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Contents

Special Issue on Corporate Governance

This special issue is based on papers presented at a colloquium held at Queen's University Belfast on 17–18 September 2008 entitled "The Globalization of Corporate Governance? Reform pressures and processes in an era of financial crises" which assessed the current state of global regulatory practice and identified future challenges and possible responses to these. The colloquium was organised under the aegis of the Law School's ESRC-funded project, "Regulatory Regime Change in Financial Markets: the case of Sarbanes-Oxley" based at the Institute of Governance. See www.qub.ac.uk/sox/.

Financialization and corporate governance
Paddy Ireland 1

History begins: shareholder value, accountability and the virtuous state
Ciarán O'Kelly 35

Non-executive directors and corporate governance
Sally Wheeler 51

A global framework for management commentary disclosure?
Charlotte Villiers 63

The end of "comply or explain" in UK corporate governance?
Marc T Moore 85

Governance reform pressures and processes in the NHS in Scotland
Alice Belcher 105

NILQ 60(1): 1–34

Financialization and corporate governance[1]

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Corporate governance and financialization

It used to be thought that what we now call "corporate governance" was a rather complex affair, involving a range of difficult issues: productive efficiency, wealth and welfare, equity and justice.[3] Which models of the corporation and corporate governance were productively superior? Which most encouraged research and development and investment in new technologies? Which best contributed to job satisfaction, to social cohesion and to the realisation of some notion of the "good life"? In the 1970s and 1980s, as the developed capitalist world lurched from one economic crisis to another, many commentators came to believe that the more stakeholder-friendly models of the corporation found in Germany and Japan were not only socially more cohesive than their more shareholder-oriented counterparts in the US and the UK, but economically more efficient. Some continued to make this argument well into the 1990s. In 1992, for example, one of America's most influential management writers, Michael Porter, argued that American corporate ownership and governance structures were seriously defective, prioritising short-term shareholder returns over long-term productive investment. By incorporating the interests of employees, suppliers, customers and the local community, he argued, the structures found in places such as Germany and Japan "better capture[d] the social benefits that private investment brings".[4] In the UK in 1996, as the country prepared for the inevitable electoral defeat of the Conservatives and the advent of New Labour, commentators such as the business

1 This paper is based on a talk delivered to "The Globalization of Corporate Governance" colloquium held at Queen's University Belfast in September 2008. Many thanks to the participants for their comments.

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3 The term "corporate governance" emerged in the 1980s to refer to a range of issues concerning the proper management of corporations, rising rapidly to political and academic prominence as the idea that investor protection and the maximisation of shareholder value were important policy objectives gained ground. In this essay, I have taken the liberty of transporting the term back into history to describe earlier debates about the running of large joint stock corporations.

4 M Porter, "Capital disadvantage: America's failing capital investment system" (1992) 65(Sept–Oct) *Harvard Business Review* 65–82. See also M Albert, *Capitalism versus Capitalism* (New York: Four Walls Eight Windows 1993) and R Dore, *Stock Market Capitalism–Welfare Capitalism: Japan and Germany versus the Anglo-Saxons* (Oxford: OUP 2000).

economist John Kay were making very similar cases for the adoption of a conception of the corporation as a social or quasi-social institution.[5]

By this time, however, the issues surrounding corporate governance had been radically redefined and simplified. Beginning in the US in the 1970s and 1980s, with financial economists taking the lead and corporate lawyers following sheepishly in their wake, corporate governance came widely to be seen as involving a relatively simple "agency problem". Far from being a social institution as some claimed, it was argued, the corporation was a pure "fiction", a legal construct which served to facilitate private contracting.[6] It was nothing more than a nexus of contracts, including, crucially, one between managers and shareholders, the suppliers of capital. The key governance question was how could agent-managers be made to act in the interests of their shareholder-principals? The rights-based arguments for shareholder primacy which resulted from these assertions about the contractual nature of corporations were reinforced by consequentialist claims that the exclusive pursuit by managers of the shareholder interest also served to maximise productive efficiency and aggregate social wealth and welfare.[7] The result was that, by the early 1990s, the mainstream corporate governance agenda had been radically stripped down and many of the issues it had previously encompassed dismissed as irrelevant. Recognition of the contractual nature of the corporation, argued two leading American corporate law scholars, Frank Easterbrook and Daniel Fischel, "remove[d] from the field" many of the "interesting questions" that had hitherto attracted the attention of legal scholars, such as: "What is the goal of the corporation? Is it profit and for whom? Social welfare more broadly defined?" Corporate governance was about markets and contracts; about devising ways of ensuring that managers single-mindedly pursued the shareholder interest. The "interesting questions", Easterbrook and Fischel cheerfully informed the world, could therefore be answered with a conversation-stopping "Who cares?"[8]

These ideas about the subject matter of corporate governance paved the way for the emergence, initially in the US and the UK but spreading elsewhere, of the idea of "shareholder value". According to the shareholder value model of the corporation, which rose rapidly to prominence in the 1990s, the object of corporate governance is simply to ensure that managers act so as to maximise shareholder value – meaning, in essence, the dividends and capital gains accruing to shareholders.[9] To achieve this end, various strategies have been deployed. Some of them – accounting regulation and the sorts of things embodied in the UK's Combined Code on Corporate Governance – essentially operate

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5 J Kay and A Silberston, "Corporate governance" (1995) 14 *National Institute Economic Review* 84. See also W Hutton, *The State We're In* (London: Vintage 1996), calling for the establishment of a "stakeholder capitalism". They were encouraged by Tony Blair and New Labour's brief flirtation with the idea of "the stakeholder society". Although occasionally wheeled out, however, e.g. in relation to pensions, stakeholding never really emerged as the Big Idea that many thought it might become.

6 Except in relation to the limited liability of shareholders, in which context the contractualist's "fictional entity" springs suddenly and miraculously to life: see P Ireland, "Property and contract in contemporary corporate theory" (2003) 23 *Legal Studies* 453 at 474–5.

7 For a critical account of the shift from rights-based (ownership) to consequentialist (efficiency) defences of shareholder primacy, see P Ireland, "Defending the rentier: corporate theory and the reprivatization of the public company" in J Parkinson, A Gamble and G Kelly (eds), *The Political Economy of the Company* (Oxford: Hart 2001) 141–73.

8 F Easterbrook and D Fischel, *The Economic Structure of Corporate Law* (Cambridge MA: Harvard UP 1991), pp. 35–6.

9 As Julie Froud et al. point out, the rhetoric of "shareholder value" is actually very "malleable" and has been "appropriated and inflected" by a range of different groups seeking to justify their behaviour: J Froud, S Johal, A Leaver and K Williams, *Financialization and Strategy: Narrative and numbers* (London: Routledge 2006), pp. 4, 8–9, 36.

from *within* the corporation and focus on such things as the use of (allegedly) independent non-executive directors to monitor managers and executive remuneration packages linked to performance as measured by share price. Others, such as the encouragement of an active takeover market – the "market for corporate control" – operate from *without*.

By the mid–late 1990s, when the US and UK economies seemed to be faring better than their main rivals, the Anglo-American, shareholder value model of the corporation and corporate governance was being widely lauded as economically superior, leading two American academics famously to announce "the end of corporate history".[10] Indeed, during this period the establishment of Anglo-American-style corporations around the world became a key element of the neoliberal, "Washington Consensus", policy packages that international agencies, such as the World Bank and the International Monetary Fund, set about imposing on the developing world. When the OECD (Organisation for Economic Co-operation and Development) Principles of Corporate Governance first emerged in 1999 following the East-Asian financial crisis of 1997–98, it was clear that they were firmly rooted in an Anglo-American, stock market-based, shareholder-oriented model of the corporation, notwithstanding nods in the direction of diversity.[11]

Enron and the other corporate scandals that greeted the new millennium made claims about the "end of corporate history" seem a tad premature, but did little to shift the focus of the corporate governance agenda. The protection of investors and the maximisation of shareholder value remained the principle policy goals. They still are. The working assumption of policymakers continues to be that corporate governance is an agency problem and that the standard devices for protecting shareholders would work if only they were better designed and implemented. Thus far, therefore, the goal of reform has been to try to create improved versions of the standard 1990s measures; to do more of the same only better. Thus, in the UK, the Higgs Review on the role and effectiveness of non-executive directors sought more effective board supervision of executives and was used to beef up the Combined Code, while endorsing the existing self-regulatory, non-prescriptive approach. In the US, on the other hand, the response to the scandals was legislative, but the Sarbanes-Oxley Act similarly left the fundamental tenets of the existing shareholder-value-oriented structures of governance firmly intact.[12]

It remains to be seen how far the consensus which has prevailed will be shaken by the economic and financial crisis in which we are now embroiled. This paper argues that it is to be hoped that it will be, for corporate governance, and Anglo-American corporate governance in particular, is in need of radical rather than ameliorative reform. Among the things that the current economic and financial crisis has highlighted is the deeply dysfunctional nature of the highly financialized corporate cultures and systems of governance that have developed in recent decades, particularly in places such as the US and the UK. In order to develop a better understanding of the nature of these financialized forms of governance, this paper briefly sketches the rise, retreat and recent resurgence of

10 H Hansmann R Kraakman, "The end of history for corporate law" (2001) 89 *Georgetown Law Journal* 439.

11 See S Soederberg, *The Politics of the New Financial Architecture* (London: Zed Books 2004), ch. 5. The principles were revised in 2004. Compliance with them is theoretically voluntary, but in practice it is near compulsory for states who wish to retain their credibility with foreign investors.

12 See D Higgs, *Review of the Role and Effectiveness of Non-executive Directors* (London: DTI January 2003); the Public Company Accounting Reform and Investor Protection Act 2002, known as Sarbanes-Oxley (SOX). George W Bush claimed that the Act implemented the "most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt": *New York Times*, 31 July 2002. SOX sought, amongst other things, to establish new or enhanced standards for the boards of US public companies and established a new quasi-public agency, the Public Company Accounting Oversight Board to regulate accounting firms in their capacities as auditors of public companies.

financial power and traces its impact on the way in which corporations have been run. En route, it examines the critiques of financialization and financialized corporate governance developed by writers such as Thorstein Veblen, Adolf Berle, R H Tawney, Harold Laski and John Maynard Keynes in the opening decades of the 20th century. Against this backdrop, the paper suggests that the simplistic conception of corporate governance as an "agency problem", a straightforward question of investor protection, is itself a product of resurgent financial power and needs to be discarded. Corporate governance reform, it argues, is a complex, multi-faceted matter which demands that we rethink the way in which we conceptualise the large public corporation and radically revise our understanding of what corporate governance is about. The crisis in the financial system and the measures that governments around the world are being forced to take to try to rescue it, the paper concludes, may provide us with a historic opportunity to do this. In trying to map ways forward, it advocates a return to these earlier critiques for guidance as to the direction in which we should be heading.

The corporate revolution and the rise of finance capitalism

In recent years, social scientists, reflecting on the dramatic economic and social changes of recent decades, have begun to deploy a new concept, "financialization", to try to grasp what has been happening. As Greta Krippner notes, the term has been used to refer to rather different phenomena. Some have used it to refer to the growing dominance of stock-market-based over bank-based systems of capitalism; others to refer to the massive increase in (and trading of) financial property forms; still others to refer to the changes that have taken place in corporate governance and to the rise of the shareholder value corporation. Krippner herself sees it as the process whereby profits are sought through financial rather than productive channels – through the creation of and trading in financial property.[13] In similar vein, for Gerald Epstein financialization refers to "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies".[14] A number of other commentators, trying to grasp the same phenomena, have resurrected the older concept of "finance capitalism", which first appeared in the opening decade of the 20th century, arguing that a "new finance capitalism" has emerged.[15] Indeed, in recent months, more and more commentators and policymakers have begun to rummage through history for guidance as they struggle to understand the nature and causes of the financial crisis which has engulfed the global economy. In this context, the depression of the 1930s has attracted particular attention. Can history and the concepts of finance capitalism and financialization help us to grasp the nature and trajectory of contemporary corporate governance, to identify its peculiarities and weaknesses, and critically to assess the current reform agenda?

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13 G Krippner, "The financialization of the American economy" (2005) 3 *Socio-Economic Review* 173. In the US, the proportion of profits earned by financial and non-financial corporations has dramatically changed. From 1946–50, the proportion of profits earned by financial corporations averaged a little under 10%, rising with increasing rapidity thereafter, peaking at 45% in 2002 before falling back to 33% in 2006, mainly because of a sharp increase in profits among non-financial firms.

14 G Epstein, "Introduction" in G Epstein (ed.), *Financialization and the World Economy* (Cheltenham: Edward Elgar 2005), p. 3. See also "General introduction" in I Erturk, J Froud, S Johal, A Leaver and K Williams, (eds), *Financialization at Work* (London: Routledge 2008), p. 1.

15 See e.g. G Davis, "A new finance capitalism? Mutual funds and ownership re-concentration in the United States" (2008) 5 *European Management Review* 11.

The term finance capitalism was first coined by the Austrian economist Rudolf Hilferding in 1910.[16] Significantly, Hilferding's invention of the term was sparked by the "rise of the corporate economy", the processes whereby the economies of the most industrialised countries of the West came increasingly to be dominated by a relatively small number of very large incorporated joint stock companies.[17] In developing his analysis of contemporary capitalism, Hilferding drew heavily on the work of Marx, who, like Adam Smith a century earlier, had noted that the joint stock company is an organisational form which "transform[s] the actually functioning capitalist into a mere manager" and the "owner of capital into . . . a mere money-capitalist" whose interest in the firm is purely pecuniary.[18] It is an organisational form, in other words, in which the interest of shareholders tends to be predominantly, if not wholly, financial in nature and to which financialization is, in that sense, inherent. In joint stock companies the tangible, productive assets are owned by a corporate entity, a legal person "completely separate" from the company's shareholders.[19] The shareholders, the great majority of whom are pure *rentier* investors who take little or no active part in management or the monitoring of management, have no direct proprietary interest in those assets.[20] They own a quite separate and autonomous piece of intangible financial property in the form of a saleable right to revenue (dividends) to which control rights are usually attached. Intangible revenue rights of this sort, of which the corporate share is but one example, have a market value of their own based on the capitalised value of the anticipated income streams. In the case of corporate shares, this value is quite separate and different from the value of the corporation's assets. The value of all these intangible revenue rights, which Marx referred to as "fictitious capital", is inherently speculative in nature as it is derived not from their concrete properties as physical objects or from the value of any tangible assets underlying them, but from their anticipated *future* earning power – from a capitalisation of the revenues that are *expected* to accrue to them in the future. This is especially true of shares, the rate of return on which is not usually fixed in advance.[21] As a result, joint stock companies and their shares have, unsurprisingly, from their inception been associated with the fraudulent manipulation of expectations, with speculative bubbles, periods of frenzied company promotion and, of course, spectacular financial collapses.[22]

In this respect, the "corporate revolution" of the late 19th and early 20th centuries was no exception. There was a dramatic decline in owner-management, a massive increase in the number of joint stock corporations and volume of intangible financial property, and no shortage of fraud and financial manipulation. What attracted Hilferding's attention, however, was the way in which the changes in the dominant property forms had paved the way in Germany and the US, though not in the UK, for the domination of many sectors of production by a small number of financiers and industrialists. Using a wide variety of

16 R Hilferding, *Finance Capital* (London: RKP 1981 ((first published 1910)). Hilferding mixed Marxist economics with Social Democratic politics and twice served as the Minister of Finance in 1920s Germany. In *Finance Capital*, he argued that the concentration and centralisation of capital was leading to the domination of industry and commerce by large banks (finance capital) and that this was generating a socialisation of production.

17 L Hannah, *The Rise of the Corporate Economy* (London: Methuen 1976).

18 K Marx, *Capital* (London: Lawrence & Wishart, 1974), vol. 3, chs 23 and 27.

19 P Davies, *Gower's Principles of Modern Company Law* 6th edn (London: Sweet & Maxwell 1997), p. 79.

20 See P Ireland, "Capitalism without the capitalist: the joint stock company share and the emergence of the modern doctrine of separate corporate personality" (1996) 17 *Journal of Legal History* 40.

21 See Marx, n. 17 above, vol. 2, ch. 1; vol. 3, chs 23 and 27. Marx's concept of fictitious capital was used and developed by Hilferding in *Finance Capital* (n. 16 above), pp. 107–16. See also P Ireland, I Grigg-Spall and D Kelly, "The conceptual foundations of modern company law" (1987) 14 *Journal of Law & Society* 149.

22 See J Taylor, *Creating Capitalism: Joint-stock enterprise in British politics and culture, 1800–1870* (Woodbridge: Boyden Press 2006).

devices – preference and non-voting shares, debentures, voting trusts and holding companies – these financiers were able to organise the financialized ownership structures of the new corporate behemoths in such a way that they were able to exercise disproportionate power, dominating them with minority holdings. "Taking possession of six large German banks", Hilferding wrote, "would mean taking possession of the most important spheres of large-scale [German] industry."[23] Moreover, these financiers usually exercised control in a quite direct manner. In the US, for example, people like J P Morgan were famous for dominating boards using nominees and complex networks of interlocking directorships.[24] The form of capitalism which emerged from this, one in which productive activity (industry) was dominated by what came to be called "high finance", Hilferding dubbed "finance capitalism".

The conservative critique of financialized governance

The changes wrought by the corporate revolution and the emergence of finance capitalism on the ways in which productive activity was conducted – the processes whereby the governance of industry was financialized – were highly controversial, especially in places such as Germany[25] and the US where grave concern was expressed at the power of the so-called "money trust".[26] There emerged from this two rather different agendas for reform. One of them was rather narrow in focus and conservative in nature; the other was not only much wider in scope but markedly more radical.

In many respects, the conservative reform agenda which emerged resembles the reform agenda which has risen to dominance in recent years. Its focus was the fate of the small investor and, more especially, the fate of the small, non-controlling minority shareholder. In the UK, where industry was never dominated by finance in the same way as in the US and Germany but where the growing separation of ownership and control in large joint stock corporations had manifested itself even earlier,[27] concerns had long been expressed about the failings of "shareholder democracy" and the fate of the "private investor vis-à-vis the

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23 See Hilferding, n. 16 above, p. 368. Hilferding later partially qualified this claim following criticisms that he had exaggerated the strength of the banks. In his introduction to the new German edition of the book, however, Eduard Marz defended Hilferding's position, arguing that while his critics may have been right on specific points, the substance of Hilferding's thesis was sound: see T Bottomore, "Introduction" to Hilferding, n. 16 above, p. 6. More recently, Alexander Dyck has also defended this view: "Comment" in R Morck (ed.), *A History of Corporate Governance Around the World* (Chicago: Chicago UP 2007), p. 277. The key to the power of the German banks lay in bearer shares.

24 For a contemporary account of this, see L Brandeis, *Other People's Money and How the Bankers Use It* (New York: Stokes & Co. 1914). See also M Becht and J Bradford DeLong, "Why has there been so little blockholding in America?", in Morck, n. 23 above, p. 613.

25 In 1908, one German commentator, Ruhland, argued that "the word capitalism denotes today a social system in which the liberty and practice of usury is more or less completely legalized . . . money interests predominate . . . trade and robbery, gain, usury, and extortion merge into each other": quoted in G Edwards, *The Evolution of Finance Capitalism* (London, New York & Toronto: Longman's, Green & Co. 1938), p. 73.

26 The direct domination of American industry by a plutocratic financial and industrial elite (the "money trust") underlay the investigations of the Pujo Committee in 1912–13, Brandeis' *Other People's Money* (n. 24 above), and also, some argue, Frank Baum's *The (Wonderful) Wizard of Oz* (Chicago & New York: George M Hill 1900).

27 See L Hannah, "The divorce of ownership and control from 1900: re-calibrating imagined global historical trends" (2007) 49 *Business History* 404. For a critique of Hannah's view, see B Cheffins, *Corporate Ownership and Control* (Oxford: OUP 2008), ch. 7.

public company".[28] It was, however, in the US, where financial property and share ownership spread very rapidly during the course of the 1920s but where financial institutions retained de facto control of many corporations, that the conservative critique of financialized corporate governance was elaborated and developed.

It was widely believed that the financiers and investment banks that controlled many of the leading American corporations were not only engaging in self-seeking financial manipulations such as stock-watering and insider-dealing, but appropriating a disproportionate share of the profits of industry at the expense of the ordinary (middle-class) investor. This fear animated popular works such as Louis Brandeis' *Other People's Money* and William Z Ripley's *Main Street and Wall Street*.[29] It also inspired the early work of Adolf Berle. In the 1920s, when Berle was working as a corporate lawyer on Wall Street and beginning to forge a career as an academic, he became increasingly concerned about the behaviour of the managers of the largest US corporations. In a series of law journal articles, the earliest of which were gathered together in *Studies in the Law of Corporation Finance*,[30] he highlighted the vulnerability of the small, "enforced" or "public" investor in the face of increasingly absolute and often finance-dominated, managerial power.[31] Many of the directors of the large corporations which increasingly dominated American industry, Berle argued, were not only feathering their own nests but channelling the proceeds of industry to controlling minority shareholders – meaning, in most cases, to financiers and investment banks – at the expense of the small investor. Indeed, so absolute had the powers possessed by corporate managers become, they were in many cases, Berle suggested, able to determine the very content of the property rights vested in shareholders.[32]

Initially, Berle looked to the judiciary and to self-regulation by stock exchanges and investment banks to remedy these problems, seeking a significant strengthening of the fiduciary duties owed by directors to shareholders. It needed to be emphasised, he argued, that these duties were owed to *all* shareholders, not merely controlling minorities.[33] It wasn't long, however, before Berle recognised the limits of the common law and self-regulation in

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28 H B Samuel, *Shareholders' Money* (London: Sir Isaac Pitman & Sons 1933), p. vii. Samuel's book, written from the perspective of the small shareholder, criticised the reforms implemented in the Companies Act 1929 and proposed a range of new legislative reforms aimed at investor protection. For pithy observations about the inability of shareholders in mid-19th-century British railway companies to control directors and their vulnerability to fraud, see Herbert Spencer's "Railway morals and railway policy" (1654) 100 *Edinburgh Review* 420. In this context, see also F W Hirst, *The Stock Exchange* (London: Williams & Norgate 1911); and H Withers, *Stocks and Shares* 3rd edn (London: Smith, Elder & Co. 1914). According to Withers, the shareholder was "merely a necessary appendage who provides capital, takes his dividends when he can get them, and has even less voice in the management of the company than the average elector has in the conduct of the Foreign Office". It was "just as well that this should be so", given their ignorance, pp. 57–9.

29 Brandeis, *Other People's Money*, n. 24 above; W Z Ripley, *Main Street and Wall Street* (Boston: Little Brown 1927).

30 Adolf Berle, *Studies in the Law of Corporation Finance* (Chicago: Callaghan & Co. 1928).

31 Berle used the term "enforced", "public" investor to refer to those who had no choice but to put their savings "into the channels of corporation finance", either directly or indirectly through the medium of insurance companies, investments trusts, commercial banks or savings banks. Berle argued that two developments had put the small enforced investor at risk. Firstly, the lifting of earlier restrictions on managerial power which had resulted in managers acquiring "absolute powers" subject only to "embryonic . . . social controls". And, secondly, the processes whereby "concentrated minority interests" or "controlling minorities" – which he clearly associated with investment banks – had gained control of corporate assets and income streams, Berle, *Studies*, n. 30 above, pp. 43–5, 190.

32 They were, in particular, able to remove or dilute the voting rights of shareholders, concentrating power in a minority of the shares, the so-called "management stock", thereby facilitating "bankers' control"; Berle, *Studies*, n. 30 above, p. 42.

33 It was his emphasis on the protection of the shareholder interest that led Berle into his celebrated debate with another American corporate lawyer, Merrick Dodd.

this context and began to call for greater state regulation, becoming one of the leading advocates of the measures contained in the New Deal legislation.[34] Believing that the ownership of financial property was the only means whereby "men [could] carry the burdens of those parts of life which, in the nature of things afford no chance to labour: childhood, sickness, old age", Berle was very anxious to protect the holdings of the growing number of middle-class investors.[35] Indeed, he wanted not only to secure the integrity of financial property but to broaden its base; to create what he later called a "people's capitalism", something similar to the shareholding democracies sought by politicians today.[36] He wanted, says his biographer, Jordan Schwarz, to be the "Marx of the shareholder class"; to make the stock exchange "more like a savings bank and less like a roulette wheel".[37]

The radical critique of financialized governance

Although the financial world has, of course, changed a great deal since 1930, there is much in this conservative critique of financialized corporate governance that is familiar. In recent decades the corporate governance agenda has come once again to focus on the question of how shareholders and investors might be protected from the financial frauds and malfeasances perpetrated by overly powerful, largely unaccountable managers. There emerged from the first finance capitalism, however, a much more radical critique of the financialized forms of industrial governance spawned by the corporate revolution, one which was critical not merely of certain undesirable aspects of financialization but of financialization *tout court*. Leading the assault was the economist and sociologist Thorstein Veblen, the principal critic and grand theorist of American finance capitalism.[38]

Veblen argued that, with the rise of the joint stock corporation, "*industry*" – the technical processes concerned with the efficient production of useful goods; what he referred to as the "use of the industrial arts" – had fallen under the control of "*business*" – which was concerned with making money rather than things. For Veblen, "business" in this context meant "finance".[39] Increasingly, he argued, industrial processes were being managed not primarily to enhance productive efficiency and maximise output, but to secure pecuniary gains for the owners of financial property. One result of this – and of the rapid growth in the number of and markets for corporate securities – was what Veblen called the shift from a "money economy" in which product markets were dominant to a "credit economy" where capital markets were dominant.[40] Another was that money-making was becoming increasingly disconnected from what is now often referred to as the "real" economy. Large fortunes were being made not from improving productive techniques but from the creation of corporate securities (fictitious capital) through the capitalisation of

34 On this and the Berle–Dodd debate, see W Bratton and M Wachter, "Shareholder primacy's corporatist origins: Adolf Berle and *The Modern Corporation*" (2007) Georgetown Law Centre (Business, Economics and Regulatory Law), Research Paper 1021273.

35 This quotation is taken from the "The New Individualism", the famous Commonwealth Club address that Berle (and his wife) wrote for Franklin Roosevelt in September 1932: see B Bishop Berle and T Jacobs, *Navigating the Rapids 1918–71* (New York: Harcourt 1973), pp. 61–70. Berle used very similar words in one of his replies to Dodd: see "For whom corporate managers are trustees: a note" (1932) 45 *Harvard Law Review* (1932) 1365, at 1368.

36 See A Berle, *New York Times Magazine*, 1 November 1959; and *Power without Property* (New York: Harcourt 1959).

37 J Schwarz, *Liberal: Adolf A Berle and the vision of an American era* (New York: Free Press 1987), pp. 57–8, 62.

38 F G Hill, "Veblen, Berle and the modern corporation" (1967) 26 *American Journal of Economics and Sociology* 279, at 281.

39 Ibid., at p. 281.

40 T Veblen, *The Theory of Business Enterprise* (New York: Mentor 1958 (first published 1904)).

presumptive revenue streams and subsequent manipulation of their market values.[41] The problems associated with joint stock companies and the intangible revenue rights that they spawned – fraud, financial manipulation, speculation – had hitherto been confined to the relatively small joint stock sector of the economy.[42] With the corporate revolution, they were generalised.[43] For Veblen, with his technocratic bent,[44] worse still was the fact that the pursuit of financial gain by business often led to the "conscientious sabotage" of industry by corporations using their monopoly powers to reduce output and fix prices at artificially high levels – "manoeuvres [which] were disserviceable not only to community but to concerns as going business organisations".[45] Far from furthering productive efficiency, Veblen concluded, the rise of modern corporate enterprise and the domination of industry by business was impeding it.[46]

By the 1920s, by which time the direct personal control exercised by financiers like Morgan was being replaced by the impersonal, bureaucratic routines of investment banks, the focus of Veblen's assault on the financial control of corporations had shifted somewhat and in so doing acquired a rather modern ring. "Business enterprise" and "particularly American business enterprise", he argued, "habitually looks to the short run". Managers were sacrificing long-term productive gains in favour of "an enhanced rate of earnings for the time being".[47] As before, this operated against the best interests of the community, which lay "in the efficient management of . . . concern[s] as . . . industrial enterprise[s]" and was "best served by an unhampered working out of the industrial system at its full capacity without interruption or dislocation".[48] By contrast, the short-term financial interests of the "absentee owners" of industry were often best served by obstructing productive activity and conspiring against the full use of the "industrial arts; by 'deranging and retarding' the industrial system".[49]

By this time, Veblen's attack on the financial control of industry and resulting subordination of productive activity to pecuniary goals had elided into a thoroughgoing attack on the financial property forms through which this control was exercised. The classic liberal justifications for absolute property rights, he argued, simply did not apply to passive, financial property. The new absentee owners of industry had delegated the

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41 Promoters, Veblen argued, would inevitably be tempted to try to maximise perceptions of the presumptive revenue streams in order to create securities with the highest possible capital value – what Hilferding later referred to as "promoters' profit". Managers would be tempted to "induce discrepancies . . . favourable for the purchase or the sale [of corporate securities], between the actual and the putative earning-capacity of the corporation's capital". The result was that corporations were "in good part managed for tactical ends" rather than for "the benefit of the corporation as a going concern": see Veblen, *Business Enterprise*, n. 40 above, pp. 7–8, 80.

42 See Taylor, *Creating Capitalism*, n. 22 above and accompanying text.

43 As indicated above, intangible financial property – rights to receive future revenues – are inherently speculative in nature: see text preceding n. 21.

44 He was, for example, a member of The Technical Alliance, founded in 1919 by Howard Scott.

45 See Joseph Dorfman, *Thorstein Veblen and his America* (New York: Viking Press 1934), pp. 227–8.

46 Veblen described these processes in *Absentee Ownership* (New York: Viking Press 1945 (first published 1923)). See also T Veblen, *The Engineers and the Price System* (New York: Huebsch 1921).

47 Veblen, *Absentee Ownership*, n. 46 above, p. 214.

48 Veblen, *Business Enterprise*, n. 40 above, p. 78; T Veblen, *The Vested Interests and the Common Man* (New York: Huebsch 1919) , p. 93.

49 Veblen, *Vested Interests*, n. 48 above, pp. 97–8, 105. Hence Veblen's claim that business had become a parasitic growth on industry. And that the investment bankers and corporate financiers had become as restrictive of further economic development as the old landed elite. As long as business controlled industry, he argued, productive activity would inevitably be accelerated and slowed down with a view enhancing business profits.

traditional powers of ownership to managers, retaining "only its rights and immunities".[50] "Ownership" in the new corporate order had come to be radically "depersonalised" and "no longer carrie[d] its earlier duties and responsibilities". It had been stripped of the "essential part of its ordinary functions" and had come to "take the shape of an absentee ownership of anonymous corporate capital". Corporate shareholders had been reduced to the status of "anonymous pensioners" whose personal identities were irrelevant "even to the concern itself". They were, in effect, "anonymous creditors", "anonymous outsiders", who not only resembled bondholders rather than "real" owners, but whose "sole effective relation to the enterprise [was] that of a fixed 'overhead charge' on its operations".[51] They were the owners of rights to receive a "free income" drawn from "the . . . product of the underlying community".[52]

By the 1920s, more and more commentators were echoing these views about the changing status of the corporate shareholder and the blurring of the lines between debt and property, and credit and capital.[53] Although British industry had never fallen under financial control in the same way as American and German industry,[54] a very similar and equally radical critique of the *rentier* and financialized industrial governance emerged. Noting the growth of intangible financial property forms like the share, for example, the sociologist L T Hobhouse, one of the intellectual inspirations of the New Liberalism, drew a distinction between what he called "property for use" and "property for power", the latter referring to the stocks and shares of the "joint-stock system" which conferred income rights on their holders. Property for use had been "virtually abolished" in the productive sphere, Hobhouse argued, while property for power – "these investments, this capital" – had become "the governing force in the lives of thousands and millions of men scattered throughout the world". With financiers controlling and "shuffling" the "abstract pieces of capital" of the "mass of investors",

> the institution of property ha[d], in its modern form, reached its zenith as a means of giving to the few power over the life of the many, and its nadir as a means of securing to the many the basis of regular industry, purposeful occupation, freedom and self-support.[55]

The critique of the *rentier* found its most developed British expression, however, in the work of the Labour Party intellectuals and Fabians, R H Tawney and Harold Laski. In 1921 in his influential book, *The Acquisitive Society*, Tawney, clearly drawing on Veblen, launched a fierce attack on what he saw as the inherently pernicious and parasitic nature of intangible financial property forms such as the share.[56] Like Veblen, he argued that the traditional justifications for private property rights were inapplicable to property forms of this sort which divorced gain from service and reward from work. Unlike rights to tangible personal

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50 Veblen, *Absentee Ownership*, n. 46 above, p. 331.

51 Veblen, *Vested Interests*, n. 48 above, pp. 44–5.

52 Ibid., pp. 163–4.

53 See e.g. F Wood, "The status of management stockholders" (1928) 38 *Yale Law Journal* 57.

54 See e.g. D H Robertson, *The Control of Industry* (London: Nisbet 1923), pp. 81–2.

55 L T Hobhouse, "The historical evolution of property in fact and in idea", in C Gore and L T Hobhouse (eds), *Property: Its duties and rights; essays with an introduction by the Bishop of Oxford* 2nd edn (London: Macmillan 1922 (1st edn 1914)), pp. 23–4. Hobhouse, who taught at LSE, was one of the intellectual inspirations for the New Liberalism of the Liberal Party under Asquith and Lloyd George. Hobhouse argued that as property was acquired not only by individual effort but by societal organisation, it followed that it entailed obligations to society. This helped to justify redistributory policies and measures such as the new state pension.

56 R H Tawney, *The Acquisitive Society* (London: G Bell 1921). Tawney was a Christian Socialist, Fabian and member of the Labour Party. He also taught at the LSE where he was for many years a professor of economic history. He crossed paths with Veblen when he visited the US.

possessions, which could be defended on functional grounds as "indispensable to a life of decency and comfort" and as encouraging industry and individual initiative, these new intangible, passive property forms – the rights to revenue which had proliferated in recent decades – were "functionless". Indeed, in directing productive activity towards "acquisition" rather than "service to society", they were positively *dys*functional, dissipating creative energy, "corrupting the principle of industry" and distorting productive activity. In order that industry might be redirected along a more productively rational and socially beneficial path, the rights acquired through share ownership had to be attenuated and management turned into a "profession" akin to medicine and law.[57] Shareholders had to be stripped of their rights of control and relegated to the status of "creditors paid a fixed rate of interest". This would release industry from financial control and enable it to be reorganised in productively functional ways, something which, Tawney argued, would entail the adoption of different organisational forms and rights structures in different contexts.

A few years later, Harold Laski echoed these sentiments in his *Grammar of Politics*.[58] For Laski, as for Tawney, the justification and moral basis for property rights lay in their ability to perform socially useful functions. The problem was that with the rise of the joint stock corporation there had been a massive growth in functionless property. An "investing class" not involved in management had emerged, "freed from the legal obligation to labour" and "maintained in parasitic idleness".[59] Although this class inevitably tended to be "idle and wasteful", it had come to "dominate [society's] institutions". As a result, functionless property, whose objective was "simply the maximum profit", had become "the controlling factor in industrial production". With this, the "notion of function" had all but "disappear[ed] from the direction of industrial enterprise", as had the "ideal of service". Like Tawney, Laski believed that for industry to be "informed by a purpose relevant to the general well-being" it had to be "made a profession . . . informed by a principle of public service" and that for this to happen "certain changes" were "immediately . . . necessary", most notably an "alteration of the character of the owner of wealth into a person to whom a fixed dividend is paid for the use of his wealth".[60] By removing the functionless owner

57 Tawney was by no means the first to do this. Louis Brandeis, for example, had written in 1912 of the need to redefine business as a profession "which is pursued largely for others and not merely for one's self" in which "the amount of financial return is not the accepted measure of success". Among the criteria of excellence of performance selected by professions was "service to the community": L Brandeis, "Business – a profession" (October 1912) *System*, later republished in L Brandeis, *Business – A profession* (Boston: Small Maynard 1914).

58 H Laski, *A Grammar of Politics* (London: Allen & Unwin 1925). Laski devoted lengthy chapters to "Property" (ch. 5) and "Economic institutions" (ch. 9). Like Tawney and Hobhouse, who taught him, Laski was based at the LSE. He was a Fabian and member of the Executive Committee of the Labour Party. Both his and Tawney's work were read in the US. Laski also, of course, engaged in correspondence with Oliver Wendell Holmes.

59 Ibid., pp. 175, 185–6. "No one, I think", Laski wrote, "can seriously pretend that the average investor in modern business takes the slightest interest in the working of the concern from which he draws his profit. He is not searching for new methods. He does not keep himself abreast of technical discoveries and seek to enforce their use upon the management. He rarely attempts criticism of the company's operations except when he is deprived of his expected dividend; and the case is rare for him to attempt opposition to any person nominated as a director of the company. As a definite factor, indeed, he is practically obsolete . . ."; p. 484.

60 Ibid., pp. 201–9. For Laski, this attenuation of the rights of corporate shareholders was quite defensible. The distinction drawn between "owning and earning" was, he argued, "morally legitimate". Property forms granting people rights to receive part of the product of the labour of others lacked "the moral penumbra which entitle[d] them to respect". As far as he was concerned, the "abolition of the rights" of functionless property was necessary to reorient industry towards "service" and part of "the necessary path to justice". Like Tawney, Laski did not deny the right of investor–shareholders to receive an income on their capital, arguing that the state needed to protect not only the welfare of the producer and consumer but that of "the investing public". Capital was not, however, to be regarded as "the natural residuary legatee of profit" and was to receive only a fixed and limited return; pp. 184–5, 208, 477, 483.

in this way, Laski believed, the character of industry would be altered and the process of production could be "infuse[d] with the sense of responsibility it now lacks". This was a transformation, he argued, which would have to be "accomplished in very various ways", differing between industries and entailing a range of measures from outright nationalisation to public regulation. While Veblen's concerns about the governance of industry were almost entirely productivist and technocratic, however, both Tawney and Laski were also concerned about the experience of workers and the dignity of labour and sought to factor this into their proposals. Laski, for example, envisaged that any surpluses remaining after workers had been paid, investors remunerated and new investments made would be divided in equal parts between the investors, labour and management, and that workers should and would be involved in "the direction of the industry". He therefore proposed that one half of the seats on a company's board of directors be reserved for the elected representatives of labour and management.[61]

Diluted radicalism: corporate governance and the depression

Despite their influence within the Labour Party, the agenda for radical reform sketched by Tawney and Laski was not turned into concrete proposals. The Labour Party's contributions to the debates surrounding company law reform which preceded the passing of the Companies Act 1929, for example, were muted and narrow in focus.[62] In the US, however, diluted versions of the radical critique of financialized corporate governance emerged and attracted considerable support during the course of the Depression. These diluted versions of the radical reform agenda were evident in E Merrick Dodd's contributions to the Berle–Dodd debate and also in the closing chapters of Berle and Means' famous *The Modern Corporation and Private Property* which clearly drew on the work of Veblen, Tawney and Laski, albeit without attribution.[63]

Dodd, Berle and Means all recognised that the great majority of the shareholders in the large joint stock corporations, which were coming increasingly to dominate industrial production, were *rentiers* – owners of "passive property" who bore little resemblance to traditional "owners". The sheer size and economic power of these joint stock corporations and the growing distance between them and their shareholders had led to a situation in

61 Laski, *Grammar*, n. 58 above, pp. 209, 433. In his chapter on economic institutions, for example, Laski explored various possible organisational forms. Industries "urgently affected by a public character", "monopolistic in their nature", had "to be operated for use and not for profit". Here nationalisation was "the only possible method of government", though there was still considerable room for experimentation in its specific form. Other industries, like agriculture, were producing "urgent commodities which are not naturally monopolistic". Here there "may clearly be a large place for the individual producer". Still other industries were producing "commodities not invested with a public character" and here "the forms of industrial government may be as various as human ingenuity can suggest". Laski did not, therefore, "envisage anything like the disappearance of private enterprise", though its ambit would be smaller and it would be subject to much more rigorous public regulation. In all cases, "the public regulation of industry was essential"; pp. 436, 481.

62 Although both Tawney and Laski were two of the Labour Party's most influential thinkers at this time and both contributed to the 1929 manifesto, *Labour and the Nation*, the document makes little use of these ideas. Nor did the party's contributions to the debates surrounding what became the Companies Act 1929: see B Clift, "The Labour Movement and Company Law Reform 1918–45" (1999), Political Economy Research Centre (Sheffield), Research Paper 1, pp. 8–12.

63 A Berle and G Means, *The Modern Corporation and Private Property* (New York: Macmillan 1932). Berle and Means' work is, one writer suggests, permeated by "Veblenite echoes": see D M Wright, "The modern corporation – twenty years after" (1951–52) 19 *University of Chicago Law Review* 662. Berle was familiar with Veblen's work and cited him in a paper delivered shortly after the latter's death: see A Berle, assisted by G Means, "Corporations and the public investor" (1930) 20 *American Economic Review* 54. Berle, who "was not given to false modesty", conceded that *The Modern Corporation and Private Property* was not wholly original: see Schwarz, *Liberal*, n. 37 above, p. 62.

which it was clearly arguable that it was no longer appropriate to see these corporations as "private enterprises" to be run solely in the shareholder interest. On the contrary, they increasingly resembled s*ocial* or *public* institutions, a view which, as Dodd pointed out, was hard to square with the idea that they were the private property of shareholders, but perfectly defensible if one took separate corporate personality more seriously and treated them as genuinely separate entities. From this perspective, it was a short step to arguing that corporate directors owed duties not only to shareholders but to employees, consumers, creditors and society as a whole.[64] Further support for this potentially radical re-conceptualisation of the corporation came from the ever-expanding army of corporate managers, who, seeking to justify and legitimate their own growing power, began to try, as Brandeis, Tawney and others had advised, to establish themselves as a "profession". They did this in part by claiming that their job was not simply to make money for shareholders but to reorient productive activity towards "service to the community".[65]

One of the most interesting contributions to these debates was made by William O Douglas, who was shortly to become first a member and then chair of the Securities and Exchange Commission, and, later, a member of the US Supreme Court. Douglas likened the institutions of high finance to "termites" who fed off industrial enterprises. They were "interested only in immediate profit", seeing corporations as mere "pieces of paper – conglomerations of stocks, bonds, notes, debentures". Under their pernicious influence, productive industries had ceased to be "vital processes in economic society" and become "channels of money which [could] be diverted and appropriated by those in control".[66] Writing in 1934 about the new legislative framework for securities regulation, Douglas observed that many saw it as a triumph for the small investor over these predatory financiers and bankers, and that the main criticism which had been levelled at it was that it would not work to protect investors in the manner hoped. In fact, Douglas argued, a much more serious criticism could be made of the new framework: that in focusing exclusively on the protection of investors it was hopelessly backward-looking. The Securities Act, Douglas suggested, was at root "a nineteenth century piece of legislation" which was trying to turn the clock back by restoring shareholder control while failing to address the "fundamental problem of the increment of power and profit in our present forms of organization". As such, it stood at odds with the more collectivist thrust of the rest of the New Deal, which sought "greater mastery of the forces of competition and monopoly, consumption and production, prices and costs, profits and losses". What was needed, Douglas suggested, was an approach which, rather than trying to "more closely assimilate [the investor] into the enterprise", sought instead to harness the "instruments of production not only for the ancient purpose of profit but for the more slowly evolving purpose of service in the sense of the public good". For Douglas, corporate self-governance and the pursuit of profit needed to be "coupled with a slowly increasing and more articulate form of public control", with "constructive planning and organization conditioned by the requirements of the public good". In other words, state regulation needed to focus not only on the protection of the investor but on the protection of the public at large.[67]

Implicit in these ideas, of course, was a rejection of the principle of shareholder primacy and of the view that corporate governance was a simple matter of shareholder

64 See E Merrick Dodd, "For whom are corporate managers trustees?" (1932) 45 *Harvard Law Review* 1147; Berle and Means, *The Modern Corporation*, n. 63 above, book 4.

65 See e.g. H C Metcalf (ed.), *Business Management as a Profession* (Chicago: A W Shaw & Co. 1927). The books of Veblen, Tawney and Laski all featured in the "selected reading list" at the end of the book.

66 W O Douglas, *Democracy and Finance* (New Haven: Yale UP 1940), pp. 6–12.

67 W O Douglas, "Protecting the investor" (1934) 23 *The Yale Review* 521.

protection. Also implicit in them was a much more socialised conception of corporations and a rejection of the view that they were purely private enterprises. Indeed, some believed that the gradual socialisation of industrial governance was going to be a more or less inevitable consequence of the corporate revolution. There was, John Maynard Keynes had written in the mid-1920s, an inevitable tendency for "joint stock institutions, when they have reached a certain age and size, to approximate to the status of public corporations rather than that of individualistic private enterprise". This "tendency of big enterprise to socialise itself", he argued, surfaced when "the owners of the capital, i.e. its shareholders, are almost entirely disassociated from the management", with the result that "the direct personal interest of the latter in the making of profit becomes quite secondary". At this point, Keynes argued, managers became more concerned about the stability and reputation of the institution, whereupon shareholders had to satisfy themselves with "conventionally adequate dividends".[68] Later, in *The General Theory*, Keynes expressed implicit approval of this relegation of the shareholder interest. Observing that interest rewarded "no genuine sacrifice", and anticipating an end to the scarcity of capital, he foresaw the gradual "euthanasia of the *rentier*". He also provided a critique of financialization and financial markets, analysing the tendency of investors, and especially "professional investors", to seek short-term gain by outguessing the market, rather than long-term gain by focusing on the underlying productive fundamentals of businesses and assessing the "probable yield of an investment over its whole life". The growing power of these investors and of financial markets was causing "speculation" to dominate "enterprise", especially in the US, something which was not only damaging to investment in productive plant and equipment but a source of serious instability. Because there was "no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable", Keynes concluded that the state, which was better placed to take a longer view and to take account of the general social interest, should take greater responsibility for "directly organising investment", advocating a "somewhat comprehensive socialisation of investment to secur[e] an approximation to full employment" and to channel resources away from speculation towards productive activity.[69]

Managerialism and the waning power of finance

Although a re-conceptualisation of the corporation as a social or quasi-social institution – something which would have required, amongst other things, a substantial revision of shareholder rights and directors' duties – was never institutionalised into Anglo-American law, it was a view of the corporation which gained considerable ground in the years after the Second World War. Underpinning its advance was a gradual decline in the power of finance. In the US, this was in part a product of the various legislative interventions of the New Deal era.[70] In fact, however, the grip of finance over American industry was already weakening in the 1920s as American corporations became financially more self-sufficient

68 J M Keynes, *The End of Laissez-Faire* (Amherst: Prometheus Books 2004 (first published 1926)).

69 J M Keynes, *The General Theory of Employment, Interest and Money* (1936), chs 12 and 24, reprinted in E Johnson and D Moggridge (eds), *The Collected Writings of John Maynard Keynes* (London: Macmillan), vol. 7. See also J H Davis, "Keynes on the socialization of investment" (1992) 19 *International Journal of Social Economics* 150.

70 These interventions are central to Mark Roe's claim (in *Strong Managers, Weak Owners* (Princeton NJ: Princeton UP 1994)) that diffused stockholder ownership in the US is a "political product"; that law "prohibited or raised the cost of institutional influence in industrial companies", "fragment[ing] financial institutions so that few institutions could focus their investments into powerful inside blocks of stock". In his view, "[American] politics never allowed financial institutions to become powerful enough to control operating firms, prefer[ring] Berle–Means corporations to the alternative of concentrated institutional ownership, which it precluded"; p. 22. On the ways in which the legislative measures of the 1930s limited the power of high finance, see Douglas, *Democracy*, n. 66 above.

and less dependent on outside finance, and as their shareholders rapidly grew in number, a development which tended, as Berle and Means famously documented, to separate ownership not only from management but from control.[71] By the 1930s, Berle and Means suggested, both the *internal*, shareholder-based controls over managers – the various mechanisms and processes operating within the corporation to secure ultimate shareholder control – and the *external*, market-based disciplines to which they were subject – those derived from product and capital market competition – had become less effective.[72]

It was on this basis that so-called "managerialist" theories of the corporation emerged. Broadly, these theories asserted that, with the internal and external constraints on them loosened, corporate managers no longer needed to profit maximise and had acquired considerable discretion in the determination of corporate goals. "Sectional" managerialists suggested that these newly liberated managers were pursuing their own self-interest and were likely to continue to do so in the future;[73] by contrast, "non-sectional" managerialists suggested that they were beginning to balance a range of different interests and that this trend was leading to the emergence of genuinely "socially responsible" corporations.[74] By the 1950s and 1960s non-sectional managerialist ideas had become commonplace, underpinning claims that corporations were becoming more "socially responsible" and "soulful".[75] In 1955, for example, L C B Gower, doyen of post-war British company law, suggested that the emphasis that some still placed on "the profit-making element in corporate activity" now had "a slightly old-fashioned ring".[76]

In the US, the rise of the idea of the socially responsible corporation found principal expression in increasing corporate philanthropy and, more radically, in demands for the creation of multi-constituency boards.[77] In Europe, where the trade union and labour movements were significantly stronger and where there was a greater willingness to question the legitimacy of existing property relations, the debates about corporate social responsibility followed a slightly different path, focusing on one particular non-shareholding constituency, the employee, and on "industrial democracy", finding their most notable expression in the draft 5th Directive on employee representation.[78] Many of the arguments for industrial democracy, while not seeking the relegation of corporate shareholders to creditor status, had the effect of diluting their rights through alterations to voting structures and the composition of corporate boards. They also tapped into the

71 See P Sweezy, "The decline of the investment banker" (1941), reprinted in Sweezy, *The Present as History* (New York: Monthly Review Press 1953), p. 189; see also P Sweezy, "Investment banking revisited" (1982) 33(10) *Monthly Review* 1. Sweezy, a Marxist economist, was the son of the vice president of the First National Bank of New York, which was headed by George F Baker, a close friend of J P Morgan. He attended LSE in the early 1930s intending to study under Hayek, but his views took a slight leftward turn after he had attended lectures delivered by Harold Laski.

72 Berle and Means, *The Modern Corporation*, n. 63 above, part 4.

73 J Burnham, *The Managerial Revolution* (London: Putnam 1941).

74 T Nichols, *Ownership, Control and Ideology* (London: Allen & Unwin 1969).

75 See e.g. C Kaysen, "The social significance of the modern corporation" (1957) 47 *American Economic Review* 313–14.

76 L C B Gower, "Book review of Emerson & Latcham, *Shareholder Democracy* (1954)" (1955) 68 *Harvard Law Review* 922, at 927.

77 The idea of directors appointed to represent the public interest is to be found in Douglas, *Democracy*, n. 66 above, p. 42. In the 1960s and 1970s, the case for multi-constituency boards was pressed by people like Ralph Nader and Christopher Stone: see C A Harwell Wells, "The cycles of corporate social responsibility: an historical retrospective for the twenty-first century" (2002) 51 *University of Kansas Law Review* 77.

78 See Lord Wedderburn, "The legal development of corporate responsibility: for whom will corporate managers be trustees?" in K J Hopt and G Teubner (eds), *Corporate Governance and Directors' Liabilities* (Berlin & New York: Walter de Gruyter 1985), p. 3.

broader conception of "the company" now associated with stakeholding and found in the jurisprudence of Japan and a number of European countries, in which the idea of the company as a separate entity is taken more seriously and its interests treated as something more than just the financial interests of shareholders.[79]

Crucially, by this time, the power of finance and financial property owners had been significantly weakened by the new international financial architecture put in place at Bretton Woods. One of the main goals of Keynes and his American counterpart Harry Dexter White, the two principal architects of the agreement, was precisely to reduce the power of finance. In restricting and regulating the international movement of capital, White acknowledged, the new arrangements would significantly diminish the rights and power of finance and financial property owners. It would mean "less freedom for owners of liquid capital" and place "restriction[s] on the property rights of the 5 or 10 percent of persons in foreign countries who have enough wealth or income to keep or invest some of it abroad".[80] In similar vein, Keynes recognised that the implementation of capital controls of this sort would precipitate "keen political discussions [about] the position of the wealthier classes and the treatment of private property". He believed, however, that the control of capital movements was a pre-requisite of effective domestic economic management and necessary in the wider public interest.[81] Finance was to be the servant not the master. This assignment of "second-class status"[82] to the financial sector helped to lay the foundations not only for the ideas about socially responsible corporations, but for the Keynesian social compromise of the post-war years, with its emphasis on state macroeconomic management, full employment and social security and welfare. As Dumenil and Levy say, Keynesianism represented "a real encroachment on the prerogatives of finance".[83]

It is important not to overstate the extent to which corporate managers abandoned the shareholder interest and to which corporations really acted in a socially responsible manner during this period. Finance was by no means stripped of power and, despite the dampening of competition associated with rising levels of industrial concentration, the adoption of multi-divisional management structures by many large corporations saw the emergence

79 In Germany, for example, the courts developed the notion of "enterprise interest" (*unternehmensinteresse*). German ideas about the company as an enterprise whose interests encompass a number of different groups, including employees, have a long history: see A B Levy, *Private Corporations and their Control* (London: Routledge 1950), vol. 1, pp. 177–8. German finance capitalism has played a role here, for, as Wedderburn says, "the concept of a 'general collective interest' (other than the aggregated interests of individual proprietary shareholders)" was fortified in Germany by the place of the banks. The same, he suggests, "may well have been the case in Italy and France, in part through stronger 'Statist' interventions in the markets and a long tradition of credit management through the banks": Lord Wedderburn, "Companies and employees: common law or social dimension?" (1993) in *Labour Law and Freedom* (London: Lawrence & Wishart 1995), p. 81, at pp. 89–95.

80 H D White, "Preliminary draft proposal for a UN stablization fund (April 1942)" in J K Horsfield (ed.), *The International Monetary Fund 1945–65, vol 3: Documents* (Washington: IMF 1969), pp. 66–7. The goal, in the words of Henry Morgenthau, American Treasury Department secretary, was to "drive the moneylenders from the temple of international finance": quoted in E Helleiner, *States and the Re-Emergence of Global Finance* (Ithaca: Cornell UP 1994), p. 4.

81 "Letter to Roy Harrod (19 April 1942)", in Johnson and Moggridge, *The Collected Writings,* n. 69 above, vol. 25, pp. 35, 149. Keynes was not opposed to finance per se, differentiating the active financier who sensed opportunities for investment in particular productive sectors from the parasitic coupon-clipper (whom he described as an investor without a function) living off interest payments and dividends.

82 Lawrence Krause, quoted in Helleiner, *States*, n. 80 above, p. 4.

83 G Dumenil and D Levy, "Costs and benefits of neoliberalism: a class analysis" in Epstein, *Financialization*, n. 14 above, p. 23

within them of decentralised "profit centres" which competed for capital.[84] It is equally important, however, not to understate the increased room for manoeuvre that corporate managers undoubtedly possessed. By their own accounts, they were under little pressure to maximise the short-term financial performance of companies at the expense of their longer-term productive health, and were relatively insulated from investor and capital market pressures.[85] The description of the corporate world provided by people like J K Galbraith, with its technocratic managers and vestigial shareholders divorced from management and too numerous and dispersed to wield significant influence, was not, therefore, without substance.[86] Neither were the claims that managers were coming to accept that they owed responsibilities to employees, consumers, local communities and society at large, as well as to shareholders.[87] In the long post-war boom, the diminished power of finance, together with the relative strength of labour, undoubtedly impacted on corporate practices and culture. When a revised edition of *The Modern Corporation* appeared in 1968, Berle described corporate managers as "administrators of a community system" and argued that the American corporation should no longer be seen as a "business device" but as a "social institution".[88] As Young and Scott put it, in the 1970s "managers seemed to value the life and enduring success of the enterprise as the fundamental end". Satisfactory shareholder returns "*resulted* from pursuing this prime goal".[89]

The formal legal structures of governance – shareholder rights, directors' duties and the like – changed very little, however. There was no radical reform of company law. It is "remarkable", Wedderburn observes, that the development of the ideas of corporate social responsibility in the post-war decades "had no significant impact on the common law formulation of directors' duties".[90] Paradoxically, this was in part because of the ambivalence of many on the left. In the 1920s, Keynes, a Liberal, had dismissed the need for changes of this sort. There was, he had argued, "no so-called important political question so really unimportant, so irrelevant to the reorganisation of the economic life of Great Britain as the nationalisation of the railways". This was because "the battle of socialism against unlimited private profit [was] being won in detail hour by hour" as a result of the tendency of big enterprises to socialise themselves.[91] Views of this sort persisted in the 1950s and 1960s. Thus, Anthony Crosland, a leading figure among the new breed of Labour Party intellectuals, insisted that there was no need to pare down shareholder privileges or to nationalise key corporations because passive and dispersed shareholders had neither the

84 See E Herman, *Corporate Control, Corporate Power* (Cambridge: Cambridge UP 1981).

85 See D Young and P Scott, *Having Their Cake . . . How the city and big bosses are consuming UK business* (London: Kogan Page 2005), ch. 1.

86 See e.g. J K Galbraith, *The New Industrial State* (Princeton: Princeton UP 1967).

87 According to Gower, writing in 1969, it had become "common form" for managers "to declare that industry owes duties to employees, consumers and the nation, as well as to shareholders": L C B Gower, *Company Law* 3rd edn (London: Stevens 1969), p. 522.

88 "Preface to revised edition", A Berle and G Means, *The Modern Corporation and Private Property* (New York: Harcourt 1968).

89 Young and Scott, *Havng Their Cake*, n. 85, p. 20.

90 Wedderburn, "Companies", n 79 above, p. 90.

91 Keynes, *Laissez-Faire*, n. 68 above. Keynes criticised state socialism "not because it seeks to engage men's altruistic impulses in the service of society, or because it departs from laissez-faire, or because it takes away from man's natural liberty to make a million, or because it has courage for bold experiments. All these things I applaud. I criticise it because it misses the significance of what is actually happening; Because it is in fact little better than a dusty survival of a plan to meet the problems of 50 years ago, based on a misunderstanding of what someone said a 100 years ago."

desire nor the ability to exercise their control rights. For him, as for many others, radical legal reform was not necessary to socialise the corporation. The key to change lay, rather, in the education and culture of the managers who were in de facto control.[92] As the debates surrounding the Bullock proposals demonstrated, the support for industrial democracy and worker representation on the boards of directors of large corporations was also less than wholehearted among the trade union and labour movements.[93] The leading labour lawyer Otto Kahn-Freund, for example, argued that co-determination could be achieved either "in the land of collective bargaining on the pluralistic pattern" or "in the land of company law on the unitary pattern", ultimately rejecting the latter as "alien to the TU movement" and as a denial of the fundamental conflict of interest between capital and labour.[94] Others thought otherwise, however, and revived parts of the radical agenda sketched by Tawney and Laski, pressing hard not only for industrial democracy but for legal reforms which would have had the effect of diluting the rights and privileges of shareholders. There was "no reason", argued Bill Wedderburn, "not to equate [the shareholder's] position with that of a well secured creditor"; the law should "not treat the shareholder as a 'proprietor' entitled to control".[95] George Goyder expressed a similar view.[96]

Resurgent finance and the rise of the shareholder value corporation

As it turned out, they were right to do so, for the picture changed dramatically when, beginning in the 1970s, finance began to reassert its power. There were many different aspects to this resurgence. Central to it was the dismantlement of the restrictive international financial framework instituted by Bretton Woods and its replacement by a new, highly liberal order which greatly increased the options open to, and bargaining power of, finance, and paved the way for the endless money-market innovations of recent decades.[97] At the same time, financial property owners, who had previously been for the most part dispersed and fragmented, began to re-unite and re-concentrate in financial institutions, enabling

92 C A R Crosland, *The Future of Socialism* (London: Jonathan Cape 1956); and *The Conservative Enemy* (London: Jonathan Cape 1962). Claims of this sort were boosted by the belief that because the duty of directors was to act in the best interests of "the company" rather than those of shareholders, they could act in a socially responsible manner without violating the law. The courts, however, steadfastly stuck to the 19th-century identification of "the company" with its shareholders: see *Parke* v *Daily News Ltd* [1962] Ch 927.

93 The Committee of Enquiry into Industrial Democracy, chaired by Alan Bullock, was set up in 1975 in response to the EC's 5th Directive which sought to introduce something resembling German-style co-determination throughout Europe. The committee reported in 1977, the majority report recommending equal representation for shareholders and workers, plus a third group of "independent" directors; the minority report proposed German-style, minority worker representation on the top board of a two-tier structure. Much of the trade union opposition resulted from a preference for "pure" collective bargaining.

94 O Kahn-Freund. "Industrial democracy" (1977) 6 *Industrial Law Journal* 65. Kahn-Freund argued that the Bullock Report was underlain by a "reification of the company" and by the belief that it was a "self-perpetuating entity" whose interests transcended those of any of its component elements. It thus denied that the company and its shareholders were one and the same thing. Kahn-Freund argued that "the so-called interest of the company [was] always identical with an interest of its shareholders, not *the* interest but *an* interest"; the company's interests were inevitably opposed to those of its workers in ways they could never be opposed to those of its shareholders or creditors.

95 See K W Wedderburn, *Company Law Reform* (London: Fabian Society 1965); P Davies and Lord Wedderburn, "The land of industrial democracy" (1977) 6 *Industrial Law Journal* 197, supporting the Bullock proposals.

96 G Goyder, *The Responsible Company* (Oxford: Blackwells 1961). Goyder called for "participating" and "responsible" companies, membership of which would extend beyond shareholders to employees, consumers and the community. He recognised that this required "a certain subordination of the shareholders' interest" but thought that morally they were only entitled to a fair return on their investment, and not necessarily a perpetual one.

97 For an excellent account of the dismantlement of Bretton Woods, contesting the traditional account that it was the result of unstoppable technological and market forces, see Helleiner, *States*, n. 80 above.

shareholders to utilise the rights still vested in them much more effectively. During the course of the 1980s and 1990s, with labour significantly weakened, the policies pursued by more and more governments around the world became, under the mantle of neoliberalism, dominated by the concerns and interests of financial property owners.[98] From this there emerged the "new finance capitalism" and the "second financial hegemony".[99]

In the corporate context, the rise of institutional investment was especially important. In the 1950s–60s heyday of the socially responsible corporation, the great majority of shares in places such as the US and the UK were held directly by individuals who were for the most part dispersed and passive. Gradually, however, shares came increasingly to be concentrated in the hands of institutions and, with this, the control rights attached to shares – the rights which some had deemed irrelevant and redundant only a few years earlier – once more became a source of considerable power. In recent decades, armed with these rights, the institutional representatives of the owners of financial property have become collectively much more active, particularly in financial markets, developing strategies for (re)shaping corporate goals and practices. Encouraged by the agency theories developed by financial economists such as Michael Jensen, for example, they have been instrumental in getting corporate boards to make share options and other performance-related bonuses a significant part of executive remuneration. As many have noted, this has served to focus the attention of managers on share price and re-aligned their financial interests with those of shareholders, albeit in a very particular way. These changes have also, of course, contributed to the controversies surrounding the enormous pay rises which have been awarded to executives, often without any discernible connection to performance.[100]

The focus on share price has been reinforced, especially in the US and the UK, by other developments, most notably the rise of the hostile takeover and consequent emergence of an active "market for corporate control".[101] This market is not confined to corporate takeovers of other corporations. Beginning in the early 1980s, there emerged a growing number of specialist takeover firms which were prepared to borrow heavily in order to gain control of corporations which were then "restructured", their presumptive income streams recapitalised, and their securities resold at a profit.[102] After dwindling during the downturn of the late 1980s and early 1990s, debt-financed purchases of public companies of this sort – so-called leveraged buy-outs (LBOs) – had a second coming and by the early years of the new century, new actors, private equity firms, were regularly taking over medium-sized public companies or divisions of large private corporations before restructuring them and selling them on.[103] Although takeovers of this sort have brought major financial gains for

98 On the links between finance and the rise of neoliberalism, see D Harvey, *A Brief History of Neoliberalism* (Oxford: OUP 2005); G Dumenil and Dominque Levy, *Capital Resurgent* (Cambridge MA: Harvard UP 2004).

99 Davis, "A new finance capitalism?", n. 15 above; Dumenil and Levy, *Capital Resurgent*, n. 98 above, pp. 7–10, 156–67.

100 See Froud et al., *Financialization*, n. 9 above, pp. 49–64. See also I Erturk, J Froud, S Johal, A Leaver and K Williams, "Agency, the Romance of Management Pay and an Alternative Explanation" (2006), CRESC Working Papers Series, No. 23.

101 Between 1980 and 1990, for example, nearly one-third of the Fortune 500 firms received takeover bids and over 10% received hostile bids. In recent decades, mergers and acquisitions involving public companies buying other public companies have become an increasingly important activity for large corporations in the US and UK: see D Zorn, F Dobbin, J Dierkes and M-S Kwok, "The new new firm: power and sense-making in the construction of shareholder value" (2006) *Nordiske Organisationsstudier* 3.

102 Firms of this sort were not new. In the UK, for example, firms such as Slater-Walker and Hanson Trust and individuals such as James Goldsmith had pioneered similar activities in the 1960s and 1970s.

103 On the LBOs of the earlier period, see D Henwood, *Wall Street* (London & New York: Verso 1997), pp. 265–85; for an excellent and accessible account of the way in which today's private equity firms operate, see R Peston, *Who Runs Britain?* (London: Hodder & Stoughton 2008), chs 2 and 3.

both their organisers and for target company shareholders, there is little evidence that they have produced long-term improvements in the performances of the companies concerned. Indeed, the overall verdict of studies of the long-term impact of takeovers is overwhelmingly negative. This is, perhaps, unsurprising, because, as Froud et al. observe, "for all its prestige, the private equity business model is almost exactly like used-car trading", where capital is borrowed, cars purchased and cosmetically (but not mechanically) fixed up, before being resold for a quick profit over and above the cost of the borrowed money.[104] Whatever their benefits, or lack thereof, however, there is no doubt that the institutionalisation of the hostile takeover and growth of the market for corporate control has added greatly to the capital market pressures on managers, reshaping what they say and do by creating an environment in which everything is permanently up for sale. Indeed, in large American and British corporations in particular, managers have come to mimic corporate raiders, speaking and acting like financial market participants who see their enterprises as mere bundles of saleable assets capable of being bought and sold at will.

The managerial obsession with share price has been further fuelled by other developments. For example, with institutions clamouring for information upon which to base their investment decisions, in recent years security analysts have grown in number and importance.[105] This has served to divert the attention of managers from simple profitability to "meeting the estimates" for profitability used by these analysts: share prices have to be protected at all costs. This has been reflected in the increased concern shown by corporations with earnings and performance management, in the marked increase in earnings preannouncements, and in the implementation of investor relations programmes aimed at keeping the expectations of analysts in line with the firm's own forecasts. It has also become increasingly important for firms to have a plausible narrative about their strategy and performance.[106] They have thus learned how to construct corporate "narratives of strategic purpose" and to deliver numbers which corroborate their stories and meet the expectations of analysts – to "keep it going" – even if it entails using accounting gimmicks and dodges, and revenue manipulations of various sorts.[107] In short, firms have quickly learned how to play the new games into which financialization has propelled them, seeking to (appear to) maximize performance on whichever measure happens to be most favoured at any given time.[108]

The result has been a dramatic shift from the situation in the 1960s and 1970s when "firms were, by their own accounts, relatively insulated from investor preferences", to a situation in which firms are intensely sensitive to the assessments of financial market participants and to the signals emitted by the markets themselves. With financial markets playing an ever more influential role, corporate strategies have become increasingly tied to

104 Froud et al., *Financialization*, n. 9 above, p. 122; see also Peston, *Who Runs Britain?*, n. 103 above, pp. 64–7.

105 See E Zuckerman, "The categorical imperative: securities analysts and the illegitimacy discount", (1999) 104 *American Journal of Sociology* 1398; and "Focusing the corporate product: securities analysts and de-diversification" (2000) 45 *Administrative Science Quarterly* 591.

106 This is one of the main themes of Froud et al., *Financialization*, n. 9 above. In the US, this has contributed to the replacement of the CEO–COO (chief executive officer–chief operating officer) dyad by the CEO–CFO (chief finance officer) dyad, in which the key task of the CFO is to manage investor relations, market expectations and share price. As a result, lawyers, investment bankers and consultants have been recruited as CFOs, less for their technical expertise or financial integrity as for their public relations skills and "deal-making talents": see D Zorn, "Here a chief, there a chief: the rise of the CFO in the American firm" (2004) 69 *American Sociological Review* 345.

107 Froud et al., *Financialization*, n. 9 above, p. 9. See also T Smith, *Accounting for Growth* (London: Century Business 1996).

108 See Zorn et al., "The new new firm", n. 101 above.

a narrowly financial view of how firms should be run, one in which maximising stock price trumps all other goals. The result has been a shift from a "managerial" to an "investor capitalism",[109] and the rise of a shareholder value conception of the corporation and radically financialized corporate culture and form of governance. With this, says Rakesh Khurana, the image of the ideal executive has been transformed "from one of a steady, reliable caretaker of the corporation and its many constituencies to that of a swashbuckling, iconoclastic champion of shareholder value". "The ideals of professionalism", established in American business schools in the 1920s and aimed at creating "a managerial class that would run America's large corporations in a way that served the broader interests of society rather than the narrowly defined ones of capital and labour", have been swept away, relegating managers to the status of "hired hands".[110] The gospel of shareholder value has, moreover, extended its tentacles well beyond Anglo-American jurisidictions into places such as Germany and Japan.[111] It is against this backdrop that the idea of corporate governance, which first emerged in the 1980s, has rapidly risen to the status of a key technology for controlling management in the interests of investors.

Markets, neoliberalism and the mechanics of contemporary financial power

The importance of business schools and elite networks in cultivating this new, highly financialized corporate culture should not be underestimated.[112] In the UK, for example, there is clear evidence that "outside", "independent", non-executive directors have played an important role in transmitting the shareholder value culture at board level. As a number of commentators have noted, the non-executive director (NED) has become the new mechanism of directorial "interlock". NEDs do not represent the interests of specific financiers or investment banks in the same way as the nominee directors of the early 20th century, but instead enforce the general priorities of financialization.[113]

It is, however, financial markets, under whose constant shadow executives now work, that have been the key mechanism through which financial imperatives have been imposed on corporations and their executives. Indeed, herein lies one of the major differences between the finance capitalism of the early 20th century and the new finance capitalism of the early 21st. While in the former power was exercised directly by financiers and investment banks *within* corporations through board representation and thus operated at the level of the individual company, financial power is now predominantly exercised from *without*, through

109 M Useem, *Investor Capitalism* (New York: Harper Collins/Basic Books 1996).

110 R Khurana, *From Higher Aims to Hired Hands: The social transformation of American business schools* (Princeton: Princeton UP 2007), pp. 3–4, 20. There has also emerged the idea of "management . . . as a process that can be applied to all situations" in which "an affinity with what is being managed is no longer deemed necessary": Young and Scott, *Having Their Cake*, n. 85 above, p. 11. As I write, the records and reputations of many of the swashbuckling heroes of the 1990s and early 2000s – like Sir Fred ("the Shred") Goodwin of Royal Bank of Scotland – are being hastily reviewed.

111 There is a vast and well-known literature on "convergence": see e.g. J McCahery, L Renneboog, P Moerland and T Raajimalers (eds), *Corporate Governance Regimes: Convergence and diversity* (Oxford: OUP 2002). For a couple of interesting recent contributions, see G Davis and C Marquis, "The globalization of stock markets and convergence in corporate governance" in R Swedberg and V Nee (eds), *The Economic Sociology of Capitalism* (Princeton: Princeton UP 2005); R Dore, "Japan's conversion to investor capitalism" in H Whittaker and S Deakin (eds), *On a Different Path? The managerial shaping of Japanese Corporate Governance* (Oxford: OUP forthcoming 2009), ch. 5.

112 See e.g. G Davis, M Yoo and W Baker, "The small world of the American corporate elite, 1982–2001" (2003) 3 *Strategic Organisation* 301.

113 J Froud, A Leaver, G Tampubolon and K Williams, "Everything for sale: how non-executive directors make a difference" in M Savage and K Williams (eds), *Remembering Elites* (Oxford: Wiley-Blackwell 2008), arguing that directorial interlocks are "now about cultural homogenization around the corporate norm that everything is for sale (at the right price)".

the arms-length mechanism of the (stock) market. This is a form of control which not only combines concentration with liquidity, but which is ubiquitous, operating at the level of the corporate sector as a whole. It is precisely this ubiquity and lack of commitment which has enabled Anglo-American finance to wield such effective disciplinary power. The indirect power that it exercises contrasts with the more direct, but in certain respects less effective, forms of power exercised by finance in places such as Germany. Indeed, paradoxically, the more direct forms of financial control, which predominated in the early 20th century when Hilferding formulated his theories about finance capitalism and which are still to be found in jurisdictions with "blockholding", are now widely seen as problematic, for blockholding, it is argued, creates risks for minority shareholders and inhibits the operation of the market for corporate control, shackling capital to particular firms and diminishing the disciplinary and efficiency-enhancing power that it can exercise in markets.[114] On the other hand, of course, the rootedness and relative lack of mobility of this more "committed" capital also enhances the status and bargaining position of non-shareholding groups, facilitating both a more relational and more stakeholder-oriented conception of the corporation – with longer-term productive and strategic horizons – and a more "welfarist" version of capitalism.[115]

The key role played by markets in the exercise of contemporary financial power also accounts for the close links between resurgent finance and neoliberalism, with its supposition that free markets – private, contractual economic ordering and the unregulated forces of supply and demand – are the best way to maximise not only freedom but also growth, wealth and welfare. For neoliberalism champions precisely the kind of market mechanisms through which modern finance exercises its coercive power, hence claims that finance was the instigator of the transition to neoliberalism and that neoliberalism is best seen as the "ideological expression of the reasserted power of finance", its economic grand narrative.[116]

The market roots of resurgent financial power also enable us to understand why the rise of the shareholder value conception of the corporation was neither prompted nor accompanied by significant changes to the substance of company/corporate law itself. As we have seen, even when managerialist ideas were at their zenith, they were founded not on legal changes diluting shareholder rights but in the space opened up, and opportunities created, by the inability of shareholders effectively to exercise the rights they possessed. In

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114 In recent years, commentators in the US have spent much time pondering why the Anglo-American, stock market-based, public corporation, with its dispersed shareholdings and "separation of ownership and control", hasn't emerged elsewhere, particularly in the civil law jurisdictions of continental Europe. Various explanations have been offered. Some have attributed it to the absence in those jurisdictions of "high quality" corporate law offering adequate protection to investors, particularly minority shareholders. This, it is argued, inhibits the growth of external finance and capital markets and encourages blockholding: see the three articles by R La Porta, F Lopez-de-Silanas, A Shleifer and R Vishny, "Legal determinants of external finance" (1997) 52 *Journal of Finance* 1131; "Law and finance" (1998) 106 *Journal of Political Economy* 1113; and "Investor protection and corporate governance" (2000) 57 *Journal of Financial Economics* 3. Much of this work is underlain by the assumption that the exclusively shareholder-oriented Anglo-American corporation is inherently superior and economically more efficient and that it would triumph if economic forces were allowed to operate without impediment. From this perspective, which is itself premised upon an unspoken belief in a politically neutral and autonomous, market-based, transhistorical and (potentially) determining economic rationality, it is the absence (rather than the presence) of Anglo-American structures which needs to be explained, hence the tendency to attribute their failure to emerge in certain jurisdictions to legal, political and cultural *impediments* – such as inadequate investor protection or the "anti-shareholder" ideologies of social democracy.

115 See nn. 3 and 4 above. This is one of the themes of the vast "models/varieties of capitalism" literature which has grown up in the last couple of decades: see e.g. P Hall and D Soskice, *Varieties of Capitalism* (Oxford: OUP 2001).

116 See Dumenil and Levy, "Costs and benefits", n. 83 above, p. 17; Dumenil and Levy, *Capital Resurgent*, n. 98 above, pp. 1–3, 11–18; Harvey, *Brief History*, n. 98 above, ch. 3.

similar vein, the recent resurgence in shareholder power has been rooted not in any enhancement of shareholder rights but in the renewed ability of shareholders, re-united and re-concentrated in institutions, to use the rights they already possessed to impose themselves on corporations and corporate executives, both directly and indirectly through the medium of financial markets – within a largely unchanged company law regime.

Indeed, in this context, the most important rule changes have probably occurred in the rules regulating international capital flows and securities markets – in particular takeovers – rather than in company law itself. In the UK, for example, the development of the City Code on Takeovers and Mergers has been particularly important, especially general principle 7 and rule 21 on non-frustration, which place decisions on the fate of takeover bids in the hands of target-company shareholders, reducing management to the role of providing information and persuasion.[117] As Paul Davies has pointed out, institutional shareholders find it much easier to influence changes to the rules regulating securities markets than they do those of company law, for the latter are subject to the normal legislative process "where institutional investors would be only one among a number of powerful influences on the ultimate shape of the legislation", while the former have generally "been devolved to regulators which are closer to the market participants, notably the Stock Exchange and, now, the Financial Services Authority, for the listing rules and the City Panel on Take-overs and Mergers for the rules on take-overs".[118] In terms of the global spread of financialized, shareholder-oriented corporate governance, it is not insignificant that general principle 7 has been adopted in many jurisdictions around the world and is a central plank of the EU Directive on Takeovers.[119] Nor is it surprising that many in Europe saw the Directive as an attack not only on their less financialized and shareholder-oriented modes of corporate governance but on their social democratic, social market versions of capitalism, and as a result fiercely opposed it.[120]

The dominance that finance and financial interests have gained in recent years has reached well beyond the corporate realm, however. It was vital, Harold Laski argued in 1926, that the state should act to prevent corporate management from being "dominated . . . by the speculative financier".[121] In recent decades, not only has the state permitted this to happen, it has itself come to be dominated by financial interests, and speculative financial interests at that. "Guiltlessly rapacious and mentally pugnacious", wrote the journalist and former Conservative Party political advisor Hywel Williams in 2006. He continued:

> Britain's financial and business elites at least display the virtue of candour about their ultimate goals: the making of money for themselves . . . The City has won

117 The Code was developed by the City Panel on Takeovers and Mergers and is now in its 8th edition (2006).

118 P Davies, "Shareholder value, company law, and securities markets" in K J Hopt and E Wymeersch (eds), *Capital Markets and Company Law* (Oxford: OUP 2003), p. 261, at p. 277.

119 See A Dignam, "The globalisation of general principle 7: transforming the market for corporate control in Australia and Europe"(2008) 28 *Legal Studies* 96.

120 A Nilsen, *The EU Takeover Directive and the Competitiveness of European Industry* (Oxford: Oxford Council on Good Governance 2005). Also of considerable importance, though not discussed here, are the measures which have been taken to try to entrench investor rights through constitutional and quasi-constitutional means. New regulatory frameworks have been established aimed at giving them "a level of fixity outside of politics" so that they are immune to political pressures and changes in state policy. Because of their constraining effects on states of these rules, they have come to be described as representing a new form of (neo)liberal constitutionalism. The object of this "new constitutionalism", as Stephen Gill has called it, is to "provide political anchorage for capital in the long term . . . through political and legal mechanisms that are difficult to change": see S Gill, "Globalisation, market civilisation, and disciplinary neoliberalism" (1995) 24 *Millennium: Journal of International Studies* 399; and D Schneiderman, "Investment rules and the new constitutionalism" (2000) 25 *Law & Social Inquiry* 757.

121 Laski, *Grammar*, n. 58. p. 476.

> all the necessary battles for command and control. It now absorbs and directs the aims of all other power elites and thereby makes those elites subordinate to its own interests.[122]

More recently, the British financial journalist, Robert Peston, whose media star has risen as rapidly as that of the neoliberal economy has fallen, has echoed these sentiments.[123] The triumph of finance is also reflected in the way that in many parts of the world neoliberal ideas about markets, the state and the nature of individuals have become embedded in popular consciousness.[124] In recent decades, beginning in places such as the US and the UK but gradually spreading elsewhere, neoliberal ideas have come increasingly to dominate policy-making, as reflected in the search, wherever possible, for market-based solutions to social and economic problems. As their prominence in news bulletins shows, the gyrations of the financial markets have come increasingly to be seen as the key barometer of economic and social well-being.

Capitalism unleashed: wealth inequality and the new power elites

Who have been the winners and losers in this "unleashed capitalism"?[125] Unsurprisingly, with managers under pressure to distribute a larger proportion of profits as dividends and forced to target their activities at raising the market value of corporations, shareholders and financial property owners have been major beneficiaries. In many OECD countries the share of national income accruing to financial institutions and *rentier* owners of financial property was markedly higher in the 1980s and 1990s than it had been in the 1970s.[126] In the US, in the 1980s, corporations began to abandon their earlier policy of "retain and invest" and to replace it with a policy of "downsize and distribute".[127] The increase in the proportion of post-tax income distributed to shareholders which resulted, however, is relatively modest compared to that in the UK where there has been a marked upward shift in pay-outs from 13–20 per cent in the 1980s to 20–35 per cent in the 1990s and early 2000s.[128] Further financial gains have, of course, come in the form of the huge growth in the value of shares, though many of these have been wiped out in recent months.

The redistribution of the proceeds of industry away from labour to capital which has accompanied the rise of neoliberalism and the shareholder value corporation has made an important contribution to the significant growth in income and wealth inequalities which has occurred in recent years, both within and between nations.[129] In the 1980s, the trend towards greater equality which began in the 1930s came to an abrupt end and by the turn of the century the levels of inequality in countries like the US and the UK were returning to those of the pre-1914 period. This has happened despite the significant rise in the proportion of households in the developed world owning shares and other forms of

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122 H Williams, *Britain's Power Elites* (London: Constable & Robinson 2006), p. 215

123 Peston, *Who Runs Britain?*, n. 103 above. Peston is particularly scathing about the subservience of New Labour to financial interests and the City. He sees the Government's handling of the debates in early 2007 about the minimal taxes being paid by one particular group of financial intermediaries – partners in private equity firms – as an exemplification of this.

124 See Harvey, *Brief History*, n. 98 above, chs 1 and 2.

125 A Glyn, *Capitalism Unleashed* (Oxford: OUP 2006).

126 Epstein, *Financialization*, n. 14 above, pp. 4, 6: Dumenil and Levy, "Costs and benefits", n. 83 above; G Epstein and A Jayadev, "The rise of rentier incomes in OECD countries", in Epstein, *Financialization*, n. 14 above.

127 W Lazonick and M O'Sullivan, "Maximising shareholder value: a new ideology for corporate governance" (2000) 29(1) *Economy & Society* 13.

128 Froud et al., *Financialization*, n. 9 above, pp. 68, 87–8.

129 See Dumenil & Levy, *Capital Resurgent*, n. 98 above. In the developed world, especially notable is the growing rift between the top and the middle of the income and wealth range.

financial property, directly and indirectly. The suggestions that finance was being "democratised" and that a "shareholding capitalism" was emerging were always greatly exaggerated: the ownership of financial property remains very heavily concentrated in the wealthiest 5–10 per cent of the population.[130]

The benefits of financialized corporate governance have not, however, been showered only on shareholders and other owners of financial property. A number of other groups have profited hugely from financialization and the changes associated with the rise of the shareholder value corporation. The most visible beneficiaries, of course, have been corporate executives, whose remuneration has skyrocketed in recent decades. Despite claims that new forms of remuneration and mechanisms for determining executive pay – in which allegedly "independent", non-executive directors play key roles – have ensured that pay is more closely linked to performance, research suggests that the link between executive pay and performance remains very weak, whereas that between pay and firm size is strong.[131] Indeed, as some commentators have pointed out, some of the mechanisms which have been touted as the guarantors of "good governance" – disclosure and the use of remuneration committees, for example – have, if anything, ratcheted pay up and served to disconnect it still further from any meaningful assessments of performance.[132] As a result, while the 1990s, with its bull-market, is often portrayed as a decade in which managers heroically created value for shareholders and, by implication, for all of us ("we're all shareholders now"), in reality they were for the most part simply enriching themselves. From this perspective, the rhetoric of "shareholder value" and "efficiency" which has been used to justify rising executive pay merely tries to conceal what has really been going on: managerial "rent seeking" or "value skimming", "the quiet, unnoticed enrichment of the few", something "quite different from the difficult process of value creation . . . which dominates the rhetoric of shareholder value". All value skimming requires is an elite structural position, where you "can take advantage of ownership rights, deals or operations close to a large income stream".[133]

It is their proximity to large corporate income streams that also distinguishes many of the other less visible groups who have benefited from financialization and the emergence of the shareholder value corporation – a diverse bunch of corporate advisors and service-providers, securities analysts, hedge fund operators, private equity firms, city lawyers and investment banks. Some of these financial intermediaries are largely reactive, responding to corporate demands; others are proactive deal-makers. Thus, some of them, like the takeover firms described earlier, actively initiate mergers and acquisitions and make money from financial innovations, constructing and capitalising new revenue streams to create new securities ("securitisation"). As Erturk et al. say, the "high paid intermediaries such as the hedge fund principals and investment bankers of the 2000s" who have "earn[ed] fees from the increased velocity of financial dealing and the larger scale of corporate restructuring plus the supporting legal and accounting services [these] require", "have become an increasingly important group of elites".[134] These groups have a stake in an "economy of permanent restructuring", for it generates fees and income from trading, dealing, investing, advice and

130 See P Ireland, "Shareholder primacy and the distribution of wealth" (2005) 68 *Modern Law Review* 49.

131 Froud et al., *Financialization*, n. 9 above, pp. 90–4.

132 This is partly because above average performance by some corporations is used to justify higher pay for CEOs, which is then used in turn to justify higher pay for all through comparability increases: see Erturk et al., *Financialization at Work*, n. 14 above, p. 21. See also, K W Wedderburn, *The Future of Company Law: Fat cats, corporate governance and workers* (London: Institute of Employment Rights 2004), highlighting the very narrow gene pool from which non-executive directors are drawn.

133 See Froud et al., *Financialization*, n. 9 above, pp. 54–64, 94.

134 Erturk et al., *Financialization at Work*, n. 14 above, pp. 21, 27.

consultancies. They live on deals and novelty, making money from everything from acquisitions and de-mergers to new issues, from buybacks and securitisation to the re-bundling of risks. It is these intermediaries who have been largely responsible for the hyper-innovation in the capital markets that, for many years, produced billion-dollar turnovers in financial property dealings involving the various revenue rights held by firms, households and financial institutions. These are the groups who have played a key role in generating a finance-oriented corporate culture in which everything is for sale if the price is right: companies, assets and risks can be all be "bundled, unbundled and traded through coupons".[135]

If the big winners have been few in number, the losers have been many. The rise of the shareholder value model of the corporation has been costly for many other corporate stakeholders. Financialized corporate governance has led to the hollowing out of many corporations through downsizing, re-engineering, outsourcing and the like. In the words of one commentator, the "serial restructuring" which has accompanied the worship of shareholder value has "elevate[d] breach of implicit stakeholder contract into a guiding principle of management".[136] What the more privileged members of the working class in the developed world gained as owners of modest amounts of financial property – gains which in many cases have now been all but erased – they often lost in other ways. The emergence of a "neoliberal order under the aegis of finance" has contributed to the destruction of the old compromises and social alliances; to deregulation followed by re-regulation in financial interests; to higher unemployment and downward pressure on wages (whose real growth has slowed and, at times, stagnated); to reductions in job security; to the dismantling of social protection systems; to higher income and wealth inequality (testaments to the growing share of the social product accruing to the owners of financial property in the form of dividends and interest); to the financialization of everyday life; and to unpredictable currency fluctuations, reckless capital movements, growing financial instability and to what now looks like a financial crisis of major proportions. As Doug Henwood says, it is "odd that workers should be asked to trade a few extra percentage points return on their pension fund, on which they may draw some decades in the future, for 30 or 40 years of falling wages and rising employment insecurity".[137] For the less privileged (non-financial-property-owning) workers of the less developed world, of course, the consequences have been even more severe and at times disastrous.[138]

It is arguable, however, that the biggest loser has been the productive economy, for when "speculation dominates enterprise" resources are likely to be poorly allocated from a productive and social perspective. The financialization of recent decades has seen a bias towards quick short-term gain rather than new, long-term productive investment. This has been reflected since the early 1980s in the marked reduction in world growth rates from an average of 4.8 per cent in 1960–80 to 2.9 per cent in 1980–2000,[139] and in the slowdown in the growth of labour productivity from 2.5 per cent to 0.8 per cent over the same period.[140] Many have expressed concern about what they see as the profound and largely

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135 P Folkman, J Froud, S Jophal and K Williams, "Working for themselves?: Capital market intermediaries and present day capitalism" (2007) 49 *Business History* 552. See also F Dobbin and D Zorn, "Corporate malfeasance and the myth of shareholder value" (2005) 17 *Political Power and Social Theory* 179.

136 Froud et al., *Financialization*, n. 9 above, p. 100.

137 Henwood, *Wall Street*, n. 103 above, p. 293.

138 For two highly accessible and graphic accounts of the consequences of the workings of contemporary capitalism for the majority of the world's population, see P Mason, *Live Working or Die Fighting: How the working class went global* (London: Harvill Secker 2007); and M Davis, *Planet of Slums* (London: Verso 2006).

139 World Bank, *World Economic Indicators* (Washington: World Bank 2005).

140 See B Bosworth and S M Collins, *The Empires of Growth: An update* (Washington: Brookings Papers on Economic Activity, Brookings Institution 2003).

negative effects of financialization on the operations of non-financial corporations.[141] Some of these concerns have been voiced by academics,[142] and in the context of the debates surrounding corporate governance have commonly taken the form of support for, on economic grounds, stakeholder over shareholder-oriented corporations.[143] More recently, however, the expressions of concern about the damaging effects of over-powerful finance and the new governance culture on productive firms and the "real" economy coming from businesspeople and business commentators have grown. In 2007, for example, Martin Wolf of the *Financial Times*, described by Lawrence Summers as "the world's preeminent financial journalist" and well-known for his support for free markets and globalisation, wrote two articles expressing grave concerns about the economic and social effects of "unfettered finance", arguing that the new "global financial capitalism" had brought "the triumph of the global over the local, of the speculator over the manager and of the financier over the producer".[144] In similar vein, the business consultants Don Young and Pat Scott recently lamented the shift in managerial emphasis from the health of the "underlying business" to shareholder value, arguing that it has had a corrosive effect on productive performance and on levels of innovation and enterprise.[145]

Corporate theory and the legitimation of financial power

Despite the negative effects of this increasingly financialized regime of governance on production and "real" investment – and despite the extremely lopsided distribution of its pecuniary benefits, the social and psychological harms it has inflicted[146] and its contribution to successive financial crises[147] – it has garnered a remarkable amount of academic support. Financial economists with their agency theories and "efficient capital markets", management specialists with their ideas about corporate "re-engineering", and corporate law scholars with their contractual theories of the corporation[148] have all offered it intellectual sustenance. In this process, shareholder primacy has come to be justified less on

141 See e.g. J Crotty, "The neoliberal paradox: the impact of destructive product market competition and 'modern' financial markets on nonfinancial corporation performance in the neoliberal era", in Epstein, *Financialization*, n. 14 above, p. 77, identifying a "neoliberal paradox". The demand that managers extract more income from and raise the stock prices of US corporations has come at a time, Crotty argues, when economic growth has been stagnant and market competition fierce. This has led non-financial corporations to cut wages and benefits, to engage in financial frauds and deceptions and to move into finance themselves. This, he argues, has had a very negative effect on general, long-term economic prosperity.

142 See, for example, the diverse contributions to a special issue of the journal *Economy and Society* (on shareholder value) in 2000. See also the contributions to Epstein, *Financialization*, n. 14 above.

143 In the UK, see Kay and Silbertson, "Corporate governance", n. 5 above; J Parkinson, "Company law and stakeholder governance" in G Kelly, D Kelly and A Gamble (eds), *Stakeholder Capitalism* (Basingstoke: Macmillan 1997). In the US, see M Blair and L Stout, "A team production theory of corporate law" (1999) 85 *Virginia Law Review* 247.

144 M Wolf, "The new capitalism", *Financial Times*, 19 June 2007; and "Risks and rewards of today's unshackled global finance", *Financial Times*, 27 June 2007. Wolf has now made some suggestions about how the problems might be resolved in his *Fixing Global Finance* (Baltimore: Johns Hopkins UP 2008).

145 Young and Scott, *Having Their Cake*, n. 85 above, ch. 11. See also A Kennedy, *End of Shareholder Value* (Cambridge MA: Perseus 2000).

146 See e.g. the work of R Sennett, such as *The Corrosion of Character* (New York: Norton 1998); O James, *Affluenza* (London: Vermillion 2007); and A Offer, *The Challenge of Affluence* (Oxford: OUP 2006).

147 Even before the recent crash, it is reckoned that there had been more than seventy severe financial crises in developed and developing countries since 1980.

148 From the 1980s, more and more scholars, chanting the mantras of the law and economics movement, vigorously re-asserted the economic superiority of shareholder-oriented corporations, abandoning all notions of corporations as social institutions in favour of a conception of them as contractual fictions. For a critique of these theories, see Ireland, "Defending the rentier", n. 7 above.

the old-fashioned – and, as many have pointed out, highly problematic – grounds of shareholder "ownership" rights and more on the instrumental grounds that shareholder-oriented corporations are more efficient and able to deliver higher rates of growth than their rivals.[149] In a process of "collective sense-making", academics from a number of different disciplines have "cobbled together" a "new myth of the efficient firm" which endorses and promotes this model of the corporation on the basis of its alleged economic superiority.[150] Just as neoliberalism has been successfully portrayed as serving the wider social interest, so too has the Anglo-American, shareholder value corporation. A governance regime which has operated primarily in the interests of a small financial elite – a minority of substantial property owners and various capital market intermediaries – has been portrayed as operating in the interests of society as a whole. Elite power has been dressed up as efficiency.[151]

There is no doubt, however, that the support for financialized corporate governance and, indeed, for financialization more generally has also been fuelled by the belief that with the spread of both financial property and asset (especially home) ownership, the latter in a rising market, a genuine property-and-share-owning democracy, a real "people's capitalism", was being constructed. When Veblen, Tawney, Laski, Keynes and others launched their assault on the *rentier* class, it was composed of a narrow, (upper-)middle-class substratum. Nowadays, with governments encouraging the development of an "equity culture", the *rentier* class – at least in the developed world – has come to embrace a much larger proportion of the population. As a result, even though the financial property holdings (direct and indirect) of the great majority are very modest indeed,[152] more and more people have come to see themselves as having a stake in the financialized economy, and this has made it easier to build political support for shareholder-oriented corporate governance and other aspects of neoliberal policy. It has also made it easier to depict the current, narrowly drawn, investor-focused agenda for corporate governance reform as in the interests of all.

In many ways, this agenda for reform resembles the conservative agenda of the early 20th century. As we have seen, commentators such as Brandeis, Ripley and Berle did not object to the financialization of corporate governance per se. On the contrary, they saw it, amongst other things, as a way of spreading the "ownership" of industry to the middle classes. What they objected to were abusive financial practices and the unequal distribution of financialization's benefits: the lion's share of the rewards were being appropriated by a small number of financial property owners, the financiers and investment bankers exercising minority control. In similar vein, in the last decade or so much energy has been expended trying to eradicate accounting and executive malpractice within an essentially unchanged, exclusively shareholder-oriented governance regime. Indeed, in recent years the account of the nature of the corporate governance problem implicit in this agenda has been indirectly reinforced by the promotion of financial literacy education, a process aimed at getting the masses to engage in financial planning – to find out how to become sufficient owners of financial property to provide for themselves in old age – and to manage their debts. It is not insignificant that the OECD, producers in 1999 of the Principles of

149 See P Ireland, "Company law and the myth of shareholder ownership" (1999) 62 *Modern Law Review* 32.

150 Zorn et al., "The new new firm", n. 101 above.

151 The law-and-economics inspired scholarship which has dominated the field of corporate law in recent decades explains the changes which have taken place in corporate governance in terms of an evolution towards "efficiency": see Hansmann and Kraakman, "The end of history", n. 10 above. By contrast, economic sociologists explain the changes in terms of changing power configurations: see e.g. G Davis, "New directions in corporate governance" (2005) 31 *American Sociological Review* 143; Dobbin & Zorn, "Corporate malfeasance", n. 135 above.

152 See P Ireland, "Shareholder primacy", n. 130 above ; see also Ireland, "Defending the rentier", n. 7 above.

Corporate Governance, produced in 2005 a lengthy study of financial education and literacy. The vision which is being promoted is one of shareholder-oriented corporations, operating in a world of open financial markets and financially literate coupon clippers, for whom personal security is achieved not through social insurance but through ownership of assets (homes) and financial property (private pensions).[153]

Until recently, expressions of doubt about this vision had been marginalised. Gradually, however, mainstream commentators have begun to voice concerns about the effects and unequal distribution of the benefits of financialization. In early 2008, for example, after Northern Rock's collapse but before the financial earthquake, Robert Peston examined, and lamented, the growth in income and wealth inequalities, arguing that the money accruing to the "super-rich" – who with their hedge funds and private equity firms were to be found "to a large extent in the financial sector" – had become "absurdly large". We were, he argued "reconstructing a UK where the share of the national income taken by those at the pinnacle of the income scale is at levels not seen for a century"; not seen, in fact, since the era of the "first" finance capitalism.[154] What seems to have most concerned Peston, as it had Berle eighty years earlier, was not so much financialization per se but the unfair distribution of the benefits of financialized corporate governance and the impact of these inequalities on the ability of small investors to provide for themselves in old age. Thus, for Peston, "the success of private-equity and other private purchasers of businesses represents the distribution of wealth from the many – the millions of us who entrust our savings to pension funds and other institutions – to the few".[155] As the super-rich had effortlessly become richer, "millions of people ha[d] been obliged to contribute more cash than they ha[d] ever done to guarantee even a modest income on retirement". Not only that,

> some of the hard-pressed company pension schemes that were once a model of enlightened paternalism [we]re now being transferred to specially created new companies backed by the super-rich – who s[aw] in them an opportunity to make a fortune for themselves, though not for pensioners.

Since then, of course, many of these already modest pensions have further shrunk, victims of the market meltdown.[156]

It is clear, however, that Peston was aware, even at this early stage of the unfolding crisis, that the problems were more fundamental. Thus, he describes the growing inequalities in wealth as "not healthy for democracy". "Behav[ing] as though the UK is permanently on probation", the operators of hedge funds and private equity firms had overseen the "reinvention" of Britain as a tax haven in which tax avoidance had been raised to such levels that the payment of taxes had been reduced to a voluntary, almost charitable, activity.[157] Not only that, the "new super-rich" had "the means through the financing of think-tanks

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153 For an unrestrained extension of this vision, in which financial markets and financial products become the solution to more or less everything, and in which the enrichment of financial intermediaries seems somehow to become the basis of social security and justice, see R Shiller's *The New Financial Order: Risk in the 21st century* (Princeton: Princeton UP 2004).

154 Peston, *Who Runs Britain?*, n. 103 above, pp. 9, 11, 14 and ch. 1 more generally.

155 Ibid., p. 91. The activities of private equity firms have generated "a massive transfer from the have-littles to the have-loads"; p. 77.

156 Ibid., p. 22. In keeping with his concern for the small (middle-class) investor and his/her modest investments, Peston is critical of "the inadequate stewardship of public companies by the funds on which we depend for our retirement"; p. 50. They are "wimps".

157 The financier principally responsible for persuading Gordon Brown of the merits of private equity, Sir Ronald ("Ronnie") Cohen, became so embarrassed by the low levels of taxes that the beneficiaries of private equity deals were paying that he publicly suggested that they should be taxed at a higher rate than "real" venture capitalists; ibid., p. 59.

and the ownership of the media to shape government policies or to deter reform of a status quo that suits them". This led Peston to declare himself "rather less enthusiastic to be a cheerleader for the uber-capitalists".[158] Equally importantly, Peston was also clearly aware that, contrary to the standard rhetoric, the activities of financial institutions did not always, or even usually, bring productive benefits. Thus, he distinguished private equity firms, "which tend to flog off property and assets as quickly as possible after a takeover has been consummated", from "real venture capitalists", "genuine entrepreneurs" and "owners of small businesses" who create and nurture enterprises over a period of time. "American-style venture capital", according to Peston the source of much of the country's economic dynamism in recent years, was qualitatively quite different from the private equity to which Gordon Brown and New Labour had pandered. Brown's support for them, he says, was a case of "mistaken identity". Far from being good for the underlying productive enterprises,[159] private equity firms tend to view them "in a very impersonal and blinkered fashion"; as "property and chattels, and statistics about cash flows and market shares". They display "little empathetic understanding of a business as a social institution wholly dependent on its people". Private equity firms, Peston argues, are better at financial engineering than they are at successfully running businesses in the long-term.[160] It is hardly surprising that the impact of their activities on workers is unfortunate: they ruthlessly sweat all assets, human as well as capital.[161]

The resurrection of the rentier and corporate governance reform

The current crisis has made it abundantly clear that the reform of corporate governance entails much more than eradicating a bit of executive and financial malpractice, remedying a few distributional inequities and providing better mechanisms for protecting investors. The economic paradigm upon which the neoliberal vision of the future is based – a vision to which the financialized, shareholder-oriented corporation is integral – is collapsing. Much of the fictitious capital value created in recent years has proved to be transient, disappearing in a matter of months amidst an orgy of wealth destruction; so too has much of the increased "value" embodied in real estate. The attempts to broaden and deepen financial property ownership, fuelled by a mixture of working-class aspiration and – in the face of declining state pension provision – working-class need, has not generated increased security for the great majority of people. On the contrary, finance has not only demanded cutbacks in both private and public investment and growth-restricting macroeconomic policies,[162] but encouraged the reckless credit expansion, speculation and corporate rapaciousness from which we are now suffering. Financialized corporate governance has done little to boost the real physical, social and productive investments upon which society's ability to provide

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158 Peston, *Who Runs Britain?*, n. 103 above, pp. 14–15

159 Ibid., pp. 59–61, 96.

160 Ibid., pp. 46, 55–7, 77. "Much of the evidence 'proving' that private equity is good for business is", Peston argues, "of questionable depth and robustness". For a succinct account of how money is made by private equity, see pp. 64–7. "None of it", Peston observes, "is rocket-science"; p. 76. Much of the money made by these firms is attributable to the rising stock market, not outstanding management: ". . . a substantial proportion of the colossal profits made by private-equity firms over the past few years is no more the result of business genius than the profits made by someone who bought a house in central London in 2000 and sold it [in 2007]": pp. 31, 57.

161 See, for example, his account of the experience of the cleaners at Travelodge, taken over by Pemira. The cleaning time they were allowed per room was cut from 40 minutes to 25 minutes and then to 20 minutes. Only a fraction of this 100% productivity increase was distributed to them. Permira and its investors, on the other hand, made a cash profit of around £450 m: Peston, *Who Runs Britain?*, n. 103 above, pp. 44–5; see also pp. 13–14.

162 On this, see Harvey, *Brief History*, n. 98, ch. 1.

adequately for its members – and especially the young, old and sick – ultimately depends. For many, the private pension dream cultivated in places such as the US and the UK is rapidly turning into a nightmare.

Indeed, it is becoming clear that what Robert Parenteau has called the "financialization in the extreme"[163] encouraged by the attempts to spread an equity culture has made an important contribution to the collapse. As financial institutions and intermediaries "searched for new opportunities to create coupons and earn fees", they used the "financialized masses" as "feedstock".[164] People were encouraged to borrow to buy houses they couldn't afford, sometimes on a buy-to-let, interest-only-mortgage basis, and many of them then borrowed more money against the rising value of those houses. Seeing money to be made from creating and selling securities, the financial institutions which issued the mortgages, packaged the underlying prospective income streams into bonds – securitised them – and sold them on to institutional investors seeking good rates of return, aided by rating agencies who gave the new securities their unequivocal stamp of approval. Many of the money managers who bought the securities were themselves operating with borrowed money and the sales generated further piles of cash which the selling institutions could then lend. Amidst this credit explosion, billions were, of course, made from fees and consultancies, in salaries and bonuses, and from selling, lending and trading. "Finance fed finance."[165]

The crisis and the responses it has dragged from governments around the world has already shifted the centre of gravity of the policy agenda. In recent months much has been written about the need for more stringent financial regulation and for restraints to be placed on finance and financial markets. Many have called for an updated Bretton Woods; others are proposing margin requirements and Tobin-style taxes on turnover. What is required, however, is much more radical and fundamental reform, not merely a stabilisation, patching up and slowing down of the old system. Such reform might seem less likely than it was in the 1930s when both labour and the left were stronger. However, the political landscape has already changed and will change further as the crisis unfolds and the full extent of the structural problems become apparent. Until now, for example, the growing inequalities in society have been accepted by most people, in significant part, one suspects, because of the sustained economic expansion, relatively low levels of unemployment and sense of prosperity created by rising house prices and the ability to borrow against them. Will this continue? When the dust settles, how many people will continue to believe that asset and financial property ownership – equity in homes, private pensions and the like – can really provide them with security in unemployment, sickness and old age?[166]

In the corporate governance context, it needs to be recognised that the current agenda for reform, with its focus on the protection of investors in exclusively shareholder-oriented

163 R Parenteau, "The late 1990s' US bubble: financialization in the extreme", in Epstein, *Financialization*, n. 14 above, p. 111.

164 Erturk et al., *Financialization at Work*, n. 14 above, pp. 26–7.

165 Ibid., p. 26. One of the problems currently facing us is the fact that debt commitments have finally and significantly outstripped the income flows needed to service them. This is in part because borrowed funds have been used disproportionately to fund speculation and compensatory spending, and insufficiently to finance productive spending – spending which enhances the income-generating capacity of individuals and firms: see R Pollin, "Socialization of investment and euthanasia of the rentier: the relevance of Keynesian policy ideas for the contemporary US economy" (1996) 10 *International Review of Applied Economics* 49 at 55. The most systematic treatment of debt accumulation and the tendency towards financial crisis was undertaken by the American economist Hyman Minsky, whose work has received renewed attention as a result of the current crisis.

166 It is worth remembering that while we have come to see high returns to *rentiers* as both necessary (not least for pensioners) and as a good thing, Keynes envisaged and welcomed falling rates of interest and returns to financial property, leading to the "euthanasia of the *rentier*".

corporations, not only does not address many of the issues with which corporate governance should be concerned, but is part of the problem. The present conjuncture offers a historic opportunity for a root-and-branch overhaul of this agenda. The emergence and rise of the idea of the socially responsible corporation took place against the backdrop of a finance weakened by the 1930s slump, Bretton Woods and the strong state regulation of the post-war years. With finance already weakened by the current crisis and likely to be weakened still further, we now have an opportunity to re-radicalise the agenda for corporate governance reform. Where might this process start?

In the conclusion to *The General Theory*, Keynes offered little in the way of concrete policy proposals, but he did provide some important pointers as to the general goals that policy should be seeking to realise. Principal amongst them was a reduction in the returns accruing to *rentiers*; a lowering of the rate of interest. "The *rentier* aspect of capitalism", he argued, was "a transitional phase" which would "disappear when it ha[d] done its work". He therefore looked forward to, and called for, the "euthanasia of the *rentier*", of the "functionless investor", and with it "the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity value of capital". He thought this process would occur not suddenly but as a gradual "continuance of what we have seen recently in Great Britain". That it would therefore require "no revolution" was something Keynes considered "a great advantage". We should, he argued, be aiming for a situation in which the functionless investor "no longer receive[d] a bonus", at which point we could pursue policies which would allow "the intelligence and determination of executive skill of the financier [and] entrepreneur . . . to be harnessed to the service of the community on reasonable terms of reward".

Keynes linked this policy theme to another, the "somewhat comprehensive socialization of investment", arguing that the establishment of "certain central controls in matters which are now left in the main to individual initiative" and a "large extension of the traditional functions of government" would be "necessary to ensure full employment". For Keynes, these "necessary measures of socialization" would save, rather than destroy, capitalism. He welcomed this, for he rejected the system of "State socialism" which had emerged in Eastern Europe, with its full state-ownership of the means of production, and sought to retain "a wide field for the exercise of private initiative and responsibility", believing that this would preserve the "advantages of efficiency" which came from "decentralisation and the play of self-interest". He made it absolutely clear, however, that the "preservation of existing economic forms" would require their radical reform.[167] He recognised, in other words, that "leashing capitalism was the only way to save capitalism".[168] Events have not proceeded as Keynes hoped and envisaged. In recent decades, rather than doing the decent thing and quietly expiring, the *rentier* has been resurrected, with the result that speculation has indeed come to dominate enterprise in exactly the ways he feared; and it has done so, one suspects, on a scale that he would have found hard to imagine. Having failed to die peacefully and without fuss, the "*rentier* aspect of capitalism" is in need of more forcible smothering, if not elimination. What follows is, in the manner of Keynes, an attempt briefly to identify the general direction in which we should be heading using the critiques, debates and agendas for reform which were sketched, but not fleshed out, in the inter-war years in the wake of the first finance capitalism.

In a recent interview with *The Times*, Lord Myners, Gordon Brown's Financial Services Secretary (or City Minister), called for fundamental changes in the way that banks are operated. In a furious onslaught on Britain's leading bankers, Myners argued that they had

167 Keynes, *General Theory*, n. 69 above, ch. 24.

168 R Pollin, "The resurrection of the rentier" (2007) 46(July–August) *New Left Review* 140 at 142, reviewing Andrew Glyn, *Capitalism Unleashed* (2006) and whose title I have borrowed.

been guilty of serious mismanagement and been "grossly over-rewarded". They had "no sense of the broader society around them".[169] Some of these criticisms could, of course, be extended to much of the corporate sector. Given the rapacious financialized corporate culture which has developed in recent decades, however, it will not be enough merely to urge executives voluntarily to act in a socially more responsible manner – as the Government has thus far done in the banking context with little discernible success. Much more than an extension of the currently fashionable ideas about self-regulatory corporate social responsibility which have recently risen to prominence – alongside a ruthlessly shareholder-oriented model of the corporation – will be needed.[170] One of the starting points for a programme for corporate governance reform must, therefore, be a radical reconceptualisation of the large joint stock corporation as a social or quasi-social institution and a corresponding reshaping of the duties of directors and the structures of corporate regulation. To be effective, this will require a radical reassessment of the status and rights of corporate shareholders along the lines suggested by writers such as Veblen, Tawney and Laski in the 1920s and Wedderburn and Goyder in the 1960s. In large corporations, the control rights currently vested in shareholders should be attenuated or eliminated altogether, and shareholders reconceptualised as creditors or quasi-creditors entitled to a return, which might be fixed or fluctuating, but not to exclusive control rights. At the same time, the composition of corporate boards should be radically revised. The Bullock Report should be dusted off, the idea of worker–directors revived, and the possibility of multi-constituency boards (with representatives of consumers and other groups) considered in an attempt to socialise corporations and to democratise our economic institutions in a rather different way from that envisaged by advocates of the equity culture. As we try to flesh out these ideas, rather than working to a single blueprint to be applied in all cases, there should be a process of experimentation of the sort advocated by Tawney and Laski. Finally, as Keynes argued, there should indeed be a "somewhat comprehensive socialization of investment". Ironically, in the UK the basis for this has already been put in place by the Government as it has reluctantly but steadily increased its holdings of bank shares.[171] As I write, the Government's pleas for banks to start lending again are becoming ever more desperate. We already have de facto nationalised the banks, commentators are arguing; why doesn't the Government recognise this and turn them into public utilities?[172] Such an approach would not only make it easier to offer short-term sustenance to the economy, but in the longer term ensure that investment decisions were guided not by the whims of speculative global financiers seeking a quick return but by the needs of society.

These sorts of reforms above would not supplant capitalism. As Robert Pollin says, there would still be contradictions: "after all capitalism cannot function if capitalists are not getting something that they consider to be adequate profits". However, such a programme would, as Pollin says, "put capitalism back on its leash" and is a more feasible option than trying to construct a socially democratic, welfarist version of capitalism "trapped inside a

169 Interview, *The Times*, 24 January 2009.

170 On the nature of contemporary ideas about CSR, see P Ireland and R Pillay, "Corporate social responsibility in a neoliberal age" in P Utting and J Carlos Marques (eds), *Corporate Social Responsibility and Regulatory Governance: Towards inclusive development?* (Basingstoke: Palgrave Macmillan 2009 (forthcoming)).

171 It is worth remembering that Hilferding believed that the growing control that a small number of banks exercised over industry would facilitate the "socialization" of productive activity: *Finance Capital*, n. 16 above.

172 There is, of course, a sense in which there has already been a massive "socialization" of investment, though, as Simon Jenkins has recently pointed out, it has involved "giving money unconditionally to banks" to "reliev[e] the debts of private financiers", rather than investment in productive industry. "When trucks loaded with Darling's loot arrived at the Square Mile", he argues, "the banks should have been properly nationalized": "Common sense has no place on the Brown–Darling Titanic", *Guardian*, 28 January 2009.

neoliberal straightjacket". Moreover, "what would satisfy capitalists as an adequate level of profits depends on the overall political, social and moral climate", and that climate is changing.[173] The political challenges would, of course, still be formidable. An assault on the *rentier*, on finance and financial capital, is an assault on the power of money and the prerogatives of class power, and in recent years, these interests have vigorously opposed even the mildest of social and economic reforms. The ideological challenges will also be considerable. In a letter written in January 2008 to members of the G20, the British Chancellor of the Exchequer, Alistair Darling, revealed the extent to which the British Government remains wedded to a neoliberal economic paradigm. While recognising the need for "significant" institutional reform, Darling was anxious not only to "restore trust and confidence" in capital markets, but to "retain faith" in specifically "open" and "innovative" financial markets. He thus sought to stress the benefits that such markets had brought to the world economy and the role they still have to play in dealing with "climate change", the "retiree boom" and "investment in developing countries". There was, he conceded, a need "to reduce the likelihood of systemic failures", but no need for systemic reform. It was simply a matter of addressing "specific failings". Thus, we require "more active, informed and capable boards", "better due diligence and care of clients' interests", and "improved ethics"; we need "prudential" regulation of "appropriate . . . scope and reach"; we must "increase efficiency in the operation of financial markets". We need, in other words, more of the same, only better. Aware, perhaps, that one or two people might have their doubts about the adequacy of this reform agenda, Darling added that we also need to have "a fuller explanation of the benefits" of an open financial system.[174] He could not have made it clearer that there is a major battle of ideas to be fought which will not be easy to win. It is worth remembering, however, Keynes' observation that Bretton Woods saw what had previously been seen as "heretical" – capital controls – suddenly "endorsed as orthodox".[175] These are unusual times and the range of political possibility is far greater than it has been for many, many years.

173 Pollin, "Resurrection", n. 168 above, p. 150.

174 A Darling, "UK objectives for the G20 in 2009", letter to G20, 7 January 2009. It would be strangely comforting to think that Darling doesn't really believe this stuff and is merely trying to revive the financial services industry upon which Britain has become increasingly economically dependent. Gordon Brown echoed these sentiments at Davos, 31 January 2009.

175 Quoted in Helleiner, *States*, n. 80 above, p. 25.

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History begins: shareholder value, accountability and the virtuous state

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Introduction

Unlike most previous recessions, the economic shock at the heart of the global financial crisis from 2007 onwards was endogenous to the corporate form rather than external to it. While the crisis was, in immediate terms, brought on by the end of a property bubble – a more or less traditional end to a speculative frenzy in the United States and some parts of Western Europe[1] – the paradigm-shifting moment at the heart of the financial crisis saw a series of structural failings brought to a head and their supporting hypotheses – that markets are more or less perfectly efficient in their use of information and that, as a result, markets will distribute societal resources in the least wasteful manner possible – revealed as seriously flawed.

What of the corporate form itself? How are we to understand the company in the midst of growing evidence about the structural vulnerability of financialised capitalism to instability? This paper addresses the shareholder value paradigm as an accountability claim for the corporation. Shareholder value mechanisms – predominantly in the form of incentives to align the interests of management with those of shareholders – are regarded as a more efficient means for corporate governance than external regulation or direct shareholder control. Nevertheless, any accountability claim must be rooted in a sense of the virtues that legitimate the claims. Without those virtues, mechanisms of control would simply be free-floating uses of force by one section or another in society.

In large part, we must explore the gap between the portrayal of the company as an accountability vehicle and the evidence for the accountability claims made regarding the company. Moreover, we must understand these accountability claims, not as simple descriptions of mechanisms (and the virtues that underpin them),[2] but as claims *on* society: claims for virtuous corporate governance are also claims over societal resources and claims

1 For a discussion of a long series of crashes, see C P Kindleberger and R Z Aliber, *Manias, Panics and Crashes: A history of financial crises* 5th edn (Basingstoke: Palgrave Macmillan 2005).

2 For a discussion of accountability mechanisms and virtues, see M Bovens, "Two concepts of accountability" (paper presented at the Kettering Symposium on Accountability, Kettering Institution, Dayton OH, 2008). I use the term "virtue" simply to denote the moral content that must exist if some social arrangement is to legitimate. A prolonged discussion, say, of the distinction between virtues and other normative forms is beyond the scope of this paper.

to freedom from interference. Accountability in this sense is as much about the terms of a virtuous society as it is about specific mechanisms and technologies of control.

For accountability mechanisms to be legitimate, they must take place in the context of a specific moral community.[3] Arguments that, say, efficiency ought to be taken as a worthwhile goal for a society, can only have force in the context of arguments that provide it with worth and meaning. As such, we have to see arguments over shareholder value as arguments on behalf of shareholders against other possible claimants for corporate resources. Legitimacy has to emerge from the formulations of a moral community either by reconstructing the boundaries of the community or by placing new claims in the context of existing norms. Of course, normative claims made against already existing norms are subject to evidence and are testable.

The corporation is held up by agency theorists as an accountability vehicle. Accountability is taken, at least by shareholder value theorists, to be the very *raison d'être* of the company. How are we to understand this sense of accountability? Patently, the successful production of the more action-oriented orders of accountability within the modern company has not stabilised market economies. It may, however, be wrong to say that it has not served shareholders. It is possible that shareholders have been, at least during periods of economic growth, content to trade on the basis of competition between companies to innovate and to produce news that would be pleasing to the markets.

My purpose for the remainder of this paper is to examine three claims for shareholder value. Taken together, these claims, for the company as an accountability vehicle that ties managers to shareholders, rely on wider norms for their legitimation. They ought to be seen as arguments about the shape of society rather than as simply being about the corporate form. Accountability in these terms, is a matter of the struggle for resources: it is a political device. Furthermore, the shareholder value framework is tied to testable claims about how society works. These claims, it seems, either describe a company that never existed or one that no longer exists. Certainly, the financialisation of capitalism has led to the rise of the "postmodern" company, oriented towards the production of spectacles for stock market consumption rather than towards production in any traditional sense. I return to this issue below. First, I address the three claims for the company as a shareholder value-oriented accountability vehicle.

The shareholder value paradigm

The shareholder value hypothesis is one of the key hypotheses of the financialised capitalism of the 1980s onwards.[4] Seeming at times like an "all-purpose justification" for every strategic management decision,[5] the rise of the shareholder value paradigm, in

3 For a Smithian discussion of accountability formulated in moral communities, see S L Darwall, *The Second-person Standpoint: Morality, respect, and accountability* (Cambridge, MA: Harvard UP 2006).

4 On financialisation, see J Froud, S Johal, A Leaver and K Williams, *Financialization and Strategy: Narrative and numbers* (London: Routledge 2006); J Froud, A Leaver and K Williams, "New actors in a financialised economy and the remaking of capitalism" (2007) 12 *New Political Economy* 339–47; J Froud, C Haslam, S Johal and K Williams, "Shareholder value and financialization: consultancy promises, management moves" (2000) 29 *Economy and Society* 80–110; G R Krippner, "The financialization of the American economy" (2005) 3 *Socioecon Rev* 173–208; T A Kochan, "Beyond financialization: the era ahead" (2008) 30 *Comparative Labor Law and Policy Journal* 89; K Williams, "From shareholder value to present-day capitalism" (2000) 29 *Economy and Society* 1; E Engelen, "The case for financialization" (2008) 12 *Competition and Change* 111–19; M Aglietta and A Rebérioux, *Corporate Governance Adrift: A critique of shareholder value* (Cheltenham: Edward Elgar Publishing Ltd 2005); G Jackson, "A new financial capitalism? Explaining the persistence of exit over voice in contemporary corporate governance" (2008) 5 *European Management Review* 23–6.

5 Froud et al., *Financialization and Strategy*, n. 4 above, p. 38.

scholarship and in the business world, has accompanied a major shift in the level of appropriation of resources by a managerial class. The shareholder value paradigm that served to divert resources even further towards a wealthy financialised class is itself driven by a body of normative claims over how distribution ought to happen in society. These claims underpin a system of accountability claims and mechanisms that reshaped systems of corporate governance oversight in a way that allowed appropriation to take place and destabilised the global financial system on the way. At their core, in other words, the accountability mechanisms of the mainstream corporate governance paradigm – rather than being normatively and ideologically neutral roadmaps to corporate clarity and honesty – are profoundly flawed, albeit influential, political statements that have produced greater inequality in the name of market egalitarianism.

The facts of appropriation are insufficient to explain the appropriation itself. The explanation for why such a massive shift in societal power and wealth happened must lie in a shift in the political foundations of society. The story of financialisation and recent crises is not a story about gangs of "bad apples". It is about the philosophical shifts that took place in the wake of technological and regulatory changes. Although sometimes articulated as mere statements of fact, in other words, it is about ideology.

In their influential study of globalisation, shareholder value and the convergence of company law, Hansmann and Kraakman present the Anglo-American model more or less as a *fait accompli*, their comparative corporate governance argument proposed that there is "no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value".[6] Convergence in company law, they argue, ought to enable shareholder-oriented corporate governance mechanisms worldwide, rooted as they ought to be on "a broad normative consensus that shareholders alone are the parties to whom corporate managers should be accountable, resulting from widespread disenchantment with a privileged role for managers, employees, or the state in corporate affairs". This normative consensus, they write, is based on the shareholder value's being "the best means to . . . aggregate social welfare".[7] Agency and contractual corporate theorists draw on a range of conventional "normative" arguments for convergence on shareholder value. Hansmann and Kraakman rely on the most common key defence of shareholder value and of the enabling role that law ought to play in the promotion of shareholder value: that is, that its benefits are a reflection of greater corporate, economic and societal efficiencies. Sitting alongside the efficiency argument many company law theorists defend shareholder value on general democratic or egalitarian arguments. Others rely on an ownership argument: that shareholders, as property owners, ought to get their just deserts, or a varient: that shareholder value arises from residual claims. I will address ownership/residual claims and the democratic/egalitarian arguments for the shareholder value accountability mechanism before moving on to the issue of efficiency.

Claims for shareholder value

Ownership and residual claims

The ownership argument is, on the face of it, the least persuasive defence of shareholder value.[8] It is also the most normatively pure argument, in that it does not rely upon the consequences of shareholder value's being enshrined in corporate practice for it to have

6 H Hansmann and R H Kraakman, "The end of history for corporate law" (2001) 89 *Georgetown Law Journal* 439.

7 Ibid., p. 441.

8 See L Stout, "Bad and not-so-bad arguments for shareholder primacy" (2002) 75 *Southern California Law Review* 1190.

force. Rather, such is the force of the ownership argument that, *even if* shareholder value produced inefficiencies, the argument that property owners ought to receive their just deserts would still hold.

While the application of this argument to corporate governance rests with Milton Friedman,[9] it, of course, has much deeper foundations in the origins of modern property-owning capitalism. The idea of ownership is a common refrain in the business world and the media as both providing a moral guide to directors and as an explanation for decisions that have a negative impact on other internal stakeholders or on society at large.[10]

To do otherwise than to orient corporate governance towards shareholders would be to appropriate "other people's money".[11] Alternatively, as the White Paper on British company law in the run-up to the Companies Act 2006 had it, it is "crucial to effective corporate governance that the owners of the company hold the directors to account for the company's performance".[12] Ownership in these cases is valuable in itself and has positive consequences for society as a whole (through effective corporate governance).

In some ways shareholder value is a throwback to the pre-Berle and Means ownership model where ownership was regarded as an uncomplicated matter.[13] The shareholder value paradigm resurrects the owner (literally or in the residual claimant guise), but in a context where the corporate princes are no longer connected in a tangible way to their property-owning masters. Unfortunately, the ownership argument is neither normatively nor empirically tenable. On the empirical claims, it is unclear how we ought to view shareholders as owners in any meaningful sense. Share ownership does not, as a number of people have pointed out, confer ownership of a company in the same way that one might own, say, a car or a house. Shareholders do not have access to the company's assets. Nor does company law confer much more than limited rights of control and governance.[14] Neither would greater shareholder power in response to their supposed ownership rights be necessarily desirable.[15] Company law does not confer any sensible ownership claim on shareholders,

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9 M Friedman, "The social responsibility of business is to increase its profits" (1970) 122 (13 September) *New York Times Magazine* 32–3; for a wider discussion of the place of Friedman's defence of shareholder value in his overall Hayekian framework, see R Chen and J Hanson, "The illusion of law: the legitimating schemas of modern policy and corporate law" (2004) 103 *Michigan Law Review* 1–149; for a discussion placing Friedmanite and Hayekian theories in the context of the development of the British corporate economy, see L Talbot, *Critical Company Law* 1st edn (London: Routledge-Cavendish 2007), pp. 119ff.

10 Very often the frame serves both purposes. See e.g. Channel Four News, "Jon Snow interviews John Varley, Chief Executive of Barclays Bank", 14 January 2009, www.channel4.com/news/articles/business_money/extended+interview+john+varley/2903807 (last accessed 3 February 2009).

11 Talk of "other people's money" draws from Adam Smith's discussions of the joint stock company. For one discussion see D G Baird and M T Henderson, "Other people's money" (2008) 60 *Stanford Law Review* 1309–44.

12 Department of Trade and Industry, *Modernising Company Law,* White Paper (London: DTI 2002), para. 2.37; for a discussion, see R Goddard, "'Modernising Company Law': the Government's White Paper" (2003) 66 *Modern Law Review* 402–24; For a recent discussion, see Department for Business Enterprise and Regulatory Reform, *Implementation of the Directive on the Exercise of Certain Rights of Shareholders in Listed Companies: A consultation document* (London: BERR 2008), p. 55: "Principals need to effectively monitor and to some extent control their agents to ensure that managers are acting in the best interests of the company's owners and that the scope for moral hazard is minimised. . . . The proposed Directive aims to lower agency costs so that shareholders can engage more effectively and ensure the companies that they own are more efficient."

13 L Dallas, "Two models of corporate governance: beyond Berle and Means" (1988) 22 *University of Michigan Journal of Law Reform* 19–116.

14 See L E Mitchell, *Corporate Irresponsibility: America's newest export* (New Haven: Yale UP 2001), pp. 119ff; Stout, "Bad and not-so-bad", n. 8 above, pp. 1190ff.

15 L A Stout, "The mythical benefits of shareholder control" (2007) 93 *Virginia Law Review* 789–809.

although corporate governance à la agency theory is obviously replete with expectations about shareholder entitlements.[16]

Nevertheless, the ownership argument founders on the fact that real shareholder rights are only as extensive and sometimes less so than those of, for instance, creditors. Options theory, Stout tells us, suggests that "it is not only misleading to say that dispersed shareholders 'own' a public corporation, but that it is even questionable, from an economic perspective, to say that a single controlling shareholder 'owns' a closely held firm after the firm has issued debt".[17] After all, a creditor will have a greater call on the company's assets in the event of the company being wound up. It seems more sensible, as Stout argues, to say that the shareholder has traded a call-option on the company than to say that they "own" it.

The share as a commodity to be bought or sold has long loosened the tie between companies and their members.[18] In this light, the shareholders' part of the deal has resided for over a century not in the governance of the firm, but in the trading of shares as "autonomous forms of property".[19] It goes without saying that technological and regulatory changes have seen this commodification of the share intensify in the last twenty-five years. Whereas, as recently as the early 1980s, the majority of shares on the London Stock Exchange (LSE) were in private hands, that had fallen to 12.8 per cent by 2006. With foreign (presumably largely institutional) investors owning 60 per cent of stock, private financial enterprises own 44.4 per cent. That is, almost 75 per cent of domestically held stock is in the hands of institutional shareholders.[20] Shareholders, in other words, have less and less resembled owners in any conventional sense even as shareholder value rhetoric intensified.

Admittedly, the ownership argument in its Friedmanite sense is now regarded as outdated by many contractarian corporate theorists.[21] For "nexus of contracts" theorists,[22] shareholders ought not to be regarded as owners, but as "residual claimants, whose claims over corporate resources are not realisable until all outstanding contracts

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16 For a discussion of expectations beyond law, see S Worthington, "Shares and shareholders: property, power and entitlement (part 1)" (2001) 22 *Company Lawyer* 258–66; S Worthington, "Shares and shareholders: property, power and entitlement (part 2)" (2001) 22 *Company Lawyer* 307–14.

17 Stout, "Bad and not-so-bad", n. 8 above, p. 1192.

18 P Ireland, "Capitalism without the capitalist: the joint stock company share and the emergence of the modern doctrine of separate corporate personality" (1996) 17 *Journal of Legal History* 66–7.

19 Ibid., p. 42; see also Mitchell's account of the rise of the American shareholding economy, rooted as it was in the promotion of speculative share ownership, not in ownership as such: L E Mitchell, *The Speculation Economy* (San Francisco: Berrett-Koehler Publishers 2007).

20 Federation of European Securities Exchanges, *Share Ownership Structure in Europe* (Paris: Federation of European Securities Exchanges 2008), p. 83.

21 S Bainbridge, "In defense of the shareholder wealth maximization norm: a reply to Professor Green" (1993) 50 *Washington and Lee Law Review* 1427.

22 On the corporation as a nexus of contracts, see F Easterbrook and D Fischel, *The Economic Structure of Corporate Law* (Cambridge MA: Harvard UP 1991); F Easterbrook and D Fischel, "The corporate contract" (1989) 89 *Columbia Law Review* 1418–48; L Kornhauser, "The nexus of contracts approach to corporations: a comment on Easterbrook and Fischel" (1989) 89 *Columbia Law Review* 1449–60; K Litvak, "Frank Easterbrook and Daniel Fischel" in L Cohen and J Wright (eds), *Pioneers of Law and Economics* (Cheltenham: Edward Elgar 2008); M A Eisenberg, "The conception that the corporation is a nexus of contracts, and the dual nature of the firm" (1999) 24 *Journal of Corporation Law* 819–36; E F Fama and M C Jensen, "Separation of ownership and control" (1983) 26 *Journal of Law and Economics* 301–25; O Hart, "An economist's perspective on the theory of the firm" (1989) 89 *Columbia Law Review* 1757–74; W Bratton, "The 'nexus of contracts' corporation: a critical appraisal" (1989) 74 *Cornell Law Review* 407–65.

have been fulfilled".[23] "The contract structures of organizations limit the risks undertaken by most agents by specifying either fixed payoffs or incentive payoffs", Fama and Jensen tell us, so "the residual risk – the risk of the difference between stochastic inflows of resources and promised payments to agents – is borne by those who contract for the rights to net cash flows".[24] So shareholders, as residual claimants, deserve to have their interests attended to because of their weak position, relative to other stakeholders, in the distribution of assets from the firm.

Nevertheless, it is unclear how this takes us much further on from the Friedmanite ownership frame. If, as Ireland puts it, under the residual claims frame, shareholders "own not 'the company' but 'the capital,' the company itself having been spirited out of existence",[25] we are still left with many of the same problems.

For a start, "it is essential to recognize that the only time that corporate law comes close to treating shareholders like residual claimants is when the firm is actually in bankruptcy."[26] Moreover, as with the ownership argument, the residual claims argument is not aimed at empowering shareholders in concrete ways. Rather, it seeks to have managers simply attend to shareholder value in making their decisions. This is quite a different thing, say, to enforcing a dividend policy. Instead of seeking specific contractual or quasi-contractual rights, the shareholder value paradigm simply seeks the acceptance of an "ought" statement: that directors ought to have shareholders in mind when they act. Given this, the residual claims argument, on these terms, does not give us good reasons for privileging shareholders over stakeholders in a similar position when it comes to corporate governance.

Any normative appeal to the ownership or residual claimant arguments to claim desert for shareholder primacy is bound up with these empirical flaws. First, as we have seen, given the, at times, narrow range of relationships within the corporate architecture, it is difficult to ascertain why shareholders ought to be privileged. Second, however, shareholding ownership can in no way be regarded as sovereignty. Rather, shareholder value involves a claim to a strange sort of delegated sovereignty. The agency relationship as described by the advocates of shareholder value, with agents acting on the principal's behalf (though not, it seems, at their behest), relies on agents presuming the principal's interests, as they develop an agenda for the company's actions.

Finally, rather than setting out a *norm* for shareholder sovereignty arising from share ownership, shareholder value seems to entail an especially inegalitarian version of property norms, especially in terms of shareholder value's allowing directors to act "without regard to the consequences to others".[27] This Hayekian conceit leaves directors citing their duties to shareholders as a defence for their actions and shareholders being so distanced from corporate actions that they cannot be held responsible for corporate actions either. The

23 On residual claims, see E F Fama and M C Jensen, "Agency problems and residual claims" (1983) 26 *Journal of Law and Economics* 327–49; B Klein, "Contracting costs and residual claims: the separation of ownership and control" (1983) 26 *Journal of Law and Economics* 367–74; J Macey, "Economic analysis of the various rationales for making shareholders the exclusive beneficiaries of corporate fiduciary duties" (1991) 21 *Stetson Law Review* 23–44; A K Sundaram and A C Inkpen, "The corporate objective revisited" (2004) 15 *Organization Science* 350–63; O E Williamson, "Organization form, residual claimants, and corporate control" (1983) 26 *Journal of Law and Economics* 351–66; F H Easterbrook and D R Fischel, "Voting in corporate law" (1983) 26 *Journal of Law and Economics* 395–427; Eisenberg, "Conception", n. 22 above; Fama and Jensen, "Separation", n. 22 above; Hansmann and Kraakman, "The end of history", n. 6 above, p. 449.

24 Fama and Jensen, "Agency problems", n. 23 above, p. 328; see also Macey, "Economic analysis", n. 23 above.

25 P Ireland, "Company law and the myth of shareholder ownership" (1999) 62 *Modern Law Review* 33.

26 Stout, "Bad and not-so-bad", n. 8 above, p. 1193.

27 Mitchell, *Corporate Irresponsibility*, n. 14 above, p. 122.

corporate person, as Elizabeth Wolgast writes, is not "like using a stick to reach farther than the length of one's arm".[28] While Wolgast argues that "if deliberation and choice are not wedded to doing – which is to say, if the person who decides is not the one who acts – there is strong reason for arguing a person's non-responsibility",[29] the company is arguably even worse than she describes. The same person is "doing the deciding" and "doing the doing" but, as the shareholder value paradigm has it, the decisions really belong to someone else. Moreover, that "someone else" is very often the manager themselves, at least where they are a beneficiary of stock options designed to align their interests with those of other shareholders.[30] Given this, in terms of any sensible conception of delegation responsibility, the corporation is a fiction within a fiction: it separates out responsibility to the point where it simply does not exist. So, it is a vehicle for accountability that contains few if any of the conventional characteristics or responsibilities associated with property holding. In this light, the claim for shareholder value, articulated as a pure call on the moral attachment to just deserts is actually, if anything, a liberation from accountability as conventionally understood.

Democratic/egalitarian arguments

A second line of legitimating argument in underpinning shareholder value is the idea that it is ultimately a democratic and egalitarian device. This argument has two main flavours. In one, proponents of shareholder value point to the extension of shareholding through pension funds, privatisation drives and other means as taking that share ownership is now in many ways public ownership and, given that, shareholder value involves a democratising of capitalism. As Hansmann and Kraakman say, with widespread share ownerships,

> no longer do labor and capital constitute clearly distinct interest groups in society. Workers, through share ownership, increasingly share the economic interests of other equity-holders. Indeed, in the United States, union pension funds are today quite active in pressing the view that companies must be managed in the best interests of their shareholders.[31]

Indeed, not only is this shift virtuous in itself. It also places obligations of care on directors that bring them back to the residual claimants argument, though now with added moral force. As Peter Brabeck-Letmathe, CEO of Nestlé put it: "Should we fail as a business, it is [shareholders'] retirement savings which are destroyed, so they're the primary stakeholders of our company."[32] This works on a practical level because the development of layers of agents, it is supposed, will lead to the interests of "ultimate owners" being attended to by the rise of the professional institutional investor. For Hansmann and

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28 E Wolgast, *Ethics of an Artificial Person: Lost responsibility in professions and organizations* (Stanford: Princeton UP, 1992), p. 65. Wolgast is arguing about the Hobbesian artificial person, but in many ways the modern corporate person falls within the general ambit of Hobbes's concerns.

29 Ibid.

30 As Monks points out, one survey revealed that, by 1992, 97% of all stock options went to the top 15 individuals in each firm: R A Monks, "Redesigning corporate governance structures and systems for the twenty first century" (2001) 9 *Corporate Governance: An international review* 143.

31 Hansmann and Kraakman, "The end of history", n. 6 above, p. 452.

32 P Brabeck-Letmathe, "Creating Shareholder Value and Corporate Responsibility: Competing Goals?", speech given at London Business School, 2006.

Kraakman, the agency relationship driving investment funds will encourage greater shareholder activism in enforcing shareholder value claims on corporations.[33]

On the rise of the pension-fund democracy, the shareholder value argument relies on three core ideas: first, that shareholdings have truly become more extensive in a meaningful way; second, that shareholder value brings benefits to a greater range of people through this extension of shareholding; and, third, to a lesser degree for our purposes here, that the institutional infrastructure around this shareholding democracy is such that the promotion of shareholder value is locked into the system.

As a normative proposition, it scarcely matters whether or not the rise of the institutional investor actually facilitates a greater attachment to shareholder value than would otherwise be the case,[34] though it might be relevant to a wider discussion about efficiency. On the whole, though, the first two claims – that shareholdings are more extensive throughout society and that benefits accrue to increasingly indirect shareholders – ought to be met with some scepticism.

For a start, while the benefits of increased private pension and equity holdings may indeed accrue to a wider portion of the population, the benefits are disproportionately concentrated among the already better-off.[35] Indeed, while median household income for the poorest 20 per cent of households in the United States rose by 14 per cent between 1980 and 2007, the incomes of the wealthiest 5 per cent of households rose by 72 per cent.[36] Measured through tax returns and including all capital gains, the top 1 per cent of households had seen their share of all American household income rise to 20 per cent of

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33 Hansmann and Kraakman, "The end of history", n. 6 above, p. 453; this argument is current in the UK's corporate governance codes where it is imagined that the "enlightened" character of "enlightened shareholder value" will arise from the interventions of institutional investors. See Financial Reporting Council, *The Combined Code on Corporate Governance* (London: Financial Reporting Council 2008), s. 2; Institutional Shareholders' Committee, *The Responsibilities of Institutional Shareholders and Agents – Statement of principles* (London: Institutional Shareholders' Committee 2007).

34 Evidence is mixed, with some scholars and policymakers seeing potential in institutional shareholders (see A Shleifer and R W Vishny, "Large shareholders and corporate control" (1986) 94 *Journal of Political Economy* 461–88; Financial Reporting Council, *Combined Code*, n. 33 above, s. 2; Institutional Shareholders' Committee, *Responsibilities*, n. 22 above) and others expressing some scepticism; for a more sceptical approach, see J Armour, S Deakin and S J Konzelmann, "Shareholder primacy and the trajectory of UK corporate governance" (2003) 41 *British Journal of Industrial Relations* 546, who argue that institutional investors with large portfolios across a range of firms in any market "do not benefit from short-term gains achieved through the operation of the market for corporate control. They are likely to take the view that takeover bids that result in substantial gains for target shareholders bring them little gain if, over time, they do not produce enhanced returns for shareholders in bidder companies, since they will most likely hold equity stakes in both sets of firms."; see also S Gillan and L Starks, "Corporate governance proposals and shareholder activism: the role of institutional investors" (2000) 57 *Journal of Financial Economics* 275–305; S Gillan and L Starks, "Corporate governance, corporate ownership, and the role of institutional investors: a global perspective" (2003) 13 *Journal of Applied Finance* 4–22; J G Hill, "Visions and revisions of the shareholder" (2000) 48 *American Journal of Comparative Law* 39; B R Cheffins, *Corporate Ownership and Control: British business transformed* (Oxford: OUP, 2008), pp. 382ff; B Cheffins, "Current trends in corporate governance: going from London to Milan via Toronto" (1999) 10 *Duke Journal of Comparative and International Law* 13.

35 For a discussion of the distribution of equity and wealth, see P Ireland, "Shareholder primacy and the distribution of wealth" (2005) 68 *Modern Law Review* 58ff.

36 Census Bureau, "Historical income tables – households" at www.census.gov/hhes/www/income/histinc/h03AR.html (last accessed 1 February 2009); see also J McNeil, *Changes in Median Household Income: 1969 to 1996 Current Population Reports* (Washington DC: Census Bureau of the United States 1998); D Weinburg, *A Brief Look at Postwar US Income Inequality: Current Population Reports* (Washington DC: Census Bureau of the United States 1996).

the whole by 2007, with 9 per cent in the hands of the top 0.1 per cent.[37] The wealth of people in the bottom decile was more or less static in real terms. Although the raw figures are less stark in the UK, the patterns are more or less the same: the financialisation of people's savings through pensions and other vehicles has not been an egalitarian enterprise.[38] There is neither evidence of progressive redistribution (although there is plenty of evidence of *regressive* transfers) nor of a "trickle down" of resources, where the kinds of inequality that have developed in the last twenty years prove to be Pareto optimal.[39] Again, shareholder value theorists' aspirations to defend shareholder value on normative grounds are as untenable as their empirical claims are unsustainable.

As the wave of privatisations and the privatisation of pension contributions transferred vast public savings into the financial markets it is clear that, rather than wealth being redistributed, it is increasingly concentrated among the wealthiest members of society. Of these, financial capitalists have benefited the most. In the USA, the proportion of Wall Street executives (that is, of financialised capitalists) in the ultra-rich income brackets has increased markedly in the past fifteen years.[40] The transfers seem to have facilitated even greater appropriation by financial elites as an intricate network of fees, bonuses and options replaced the direct relationships between management and production.

In other words, ironically, the core motivator behind shareholder value and agency theory – incentive-based work – did not empower the shareholder. Rather, it simply allowed executives and people throughout the financial chain to divert vast resources to their own pockets. Oversight is unlikely where brokers do not maximise returns either through activism or even through long-term "investment" in a set of shares. Expecting long-term relationships, as policy-makers in the UK do, is quixotic where

> many fund managers feel unable to take long-term positions in companies, and so their buy and sell decisions are driven by short-term movements in the share price. The reason for this is that fund managers' performance is scrutinised by their clients (pension and other investment funds) on the basis of quarterly performance statistics.[41]

It is difficult, moreover to discern any shift towards long-term institutional share ownership when, albeit for a variety of complex reasons, share turnover velocity on the LSE was 154

37 See A B Atkinson and T Piketty, "Income and wage inequality in the United States (updated to 2006)" (2008), available at http://elsa.berkeley.edu/~saez/ (accessed 1 February 2009); this table is an update to T Piketty and E Saez, "Income and wage inequality in the United States, 1913–2002" in A B Atkinson and T Piketty (eds), *Top Incomes Over the Twentieth Century: A contrast between continental European and English-speaking countries* (Oxford: OUP 2007), pp. 141–225; and T Piketty and E Saez, "Income inequality in the United States, 1913–1998" (2003) 118 *Quarterly Journal of Economics* 1–39.

38 See Ireland, "Shareholder primacy", n. 35 above, pp. 62ff, for a discussion.

39 See e.g. M Aglietta and R Breton, "Financial systems, corporate control and capital accumulation" (2001) 30 *Economy and Society* 433–66; Joseph Stiglitz, meanwhile, argues that even efficient markets may not be Pareto optimal: J E Stiglitz, "Pareto optimality and competition" (1981) 36 *Journal of Finance* 235–51; futhermore, G A Cohen highlights that justice-based arguments for inequalities-as-incentives simply do not hold as normative statements: G Cohen, *Rescuing Justice and Equality* (Cambridge MA: Harvard UP 2008). They may be of pragmatic consequence but only in the context of already existing injustices relating to redistribution in society.

40 See S Kaplan and J Rauh, "Wall Street and Main Street: what contributes to the rise in the highest incomes?", paper presented at the American Finance Association 2008 New Orleans Meetings.

41 A Johnston, "After the OFR: can UK shareholder value still be enlightened?" (2006) 7 *European Business Organization Law Review* 836–37; see also I Anabtawi, "Some skepticism about increasing shareholder power", Law and Economics Research Paper Series, Research Paper No. 05–16 (Los Angeles: School of Law, University of California 2005); moreover, there is no definitive matrix for judging the divergent demands of institutional shareholders. Pressure from one set of institutional shareholders may disadvantage others. See I Anabtawi and L Stout, "Fiduciary duties for activist shareholders" (2008) 60 *Stanford Law Review* 1255–309.

per cent in 2007, up from 40 per cent in 1990.[42] This indicates that the mean stock holding period on the exchange has fallen to "substantially less than 1 year".[43] Similarly, the annual turnover of shares on the New York Stock Exchange went from 12 per cent in 1960 to 102 per cent in 2005.[44] With each transaction, remember, comes an accumulation of fees.

Further to this, we must remember that institutional investors suffer from the same agency problems that they're supposed to solve. The only difference as we move up the chain through pension funds and the like is that the information disadvantages of ostensible principals vis-à-vis their agents are even more glaring. Incentives for agents to work on their clients'/principals' behalf would only work in the presence of a coherent and accessible market for financial services. But there is no market. People lack the information to choose between pension or savings products. Or, more starkly, if their savings come straight out of wages through workplace schemes, then any link between demand and performance may all but break. Given that many people do not use their savings in this manner out of entrepreneurial or enterprising ambitions, but because the devaluation of other alternatives (pensions funded by taxation for instance)[45] has left them with little in the way of choice, it is difficult to expect that they devote their energy to performing oversight over their agents in distant and impermeable financial markets.

Finally, as events in the past decade have shown, rather than unleashing enterprise or improving the lot of the individual, the financialisation of savings has transferred substantial risk to the individual. With increasingly volatile portfolios in decline at many points in the last decade, contributors to pension funds are essentially forced to bet on the health of the markets at their point of retirement. Rather than being focused on shareholder value, the rise of the shareholding democracy has simply delivered greater appropriation by managers and financial intermediaries, a massive transfer of risk to individuals and a regressive redistribution to the wealthier members of society.

Again, as with ownership claims, co-opting convention norms about democracy into the legitimation of shareholder value is normatively and empirically untenable. The company, by these terms, is not an accountability vehicle in any conventional sense at all.

Efficiency arguments

Once we dispense with the democratic/egalitarian argument, it becomes difficult to regard any efficiency arguments as having any particular force. Nevertheless, the attachment to the social benefits of efficiency is prevalent in the literature.[46] While efficiency can have no normative force in and of itself, it is an important component in general Hayekian schema for the market: that blockholding interests will be driven out in favour of more productive parties. Benefits to all stakeholders and even general social welfare will follow. Efficiency is

42 World Federation of Exchanges, *Turnover Velocity of Domestic Shares Statistics* (Paris: World Federation of Exchanges 2007); see also table in A Pendleton and H F Gospel, "Markets and relationships: finance, governance and labour in the United Kingdom" in H F Gospel and A Pendleton (eds), *Corporate Governance and Labour Management* (Oxford: OUP 2005), p. 73.

43 D Walker, *Guidelines for Disclosure and Transparency in Private Equity* (the Walker Report) (London: British Venture Capital Association 2007), p. 10.

44 T Clarke, *International Corporate Governance: A comparative approach* (London: Routledge 2007), p. 238.

45 Ireland, "Shareholder primacy", n. 35 above, p. 53.

46 Agency theory is based on an efficiency model-based description of the company. See Fama and Jensen, "Separation", n. 22 above; Fama and Jensen, "Agency problems", n. 23 above; M C Jensen and W H Meckling, "Theory of the firm: managerial behavior, agency costs and ownership structure" (1976) 3 *Journal Of Financial Economics* 305–60; M C Jensen, "Value maximization, stakeholder theory, and the corporate objective function" (2001) 14 *Journal of Applied Corporate Finance*; Easterbrook and Fischel, *Economic Structure*, n. 22 above; K Eisenhardt, "Agency theory: an assessment and review" (1989) 14 *Academy of Management Review* 57–74.

the core principle driving the shareholder value paradigm in corporate governance and is held to be the core driver of company law. Moreover, the purported efficiency of the shareholder value paradigm is regarded as one of the strong forces behind any convergence on shareholder value: more efficient companies and regimes will drive the less efficient ones out of the game.[47]

The problem with the efficiency argument is that it is very difficult to formulate an evidence basis for a claim that a particular economic system or system of governance is more or less efficient than any other.[48] While it is possible to identify individual inefficiencies as they arise it is not possible to come up with a systematic sense of efficiency beyond a general assertion that it is a necessary consequence of unfettered markets. First off, the link between shareholder value and efficiency is tautological: efficiency is described as anything that delivers shareholder value while shareholder value is legitimated on the grounds that it is efficient.

It is not clear at any point what precisely shareholder value might entail. All shareholders may not have entirely common interests or motives.[49] At the very least they may define share values as counting over different time scales. It is unclear that shareholder value actually does provide a clearer and more transparent incentive upon which directors might build their strategies for the firm and it is certainly difficult to sustain the idea that attending to shareholder value is superior because "shareholder value is a single-valued metric that is also observable and measurable".[50] It is not necessarily a single value and observation and measurement do not float free of decisions as to what strategies will count as enhancing shareholder value. So, while a multi-stakeholder approach may well "permit managers and directors to serve no one but themselves,"[51] it is not clear that a shareholder-orientation will do any better.

How, indeed, can strategies designed to enhance shareholder value actually do so in any obvious way? The development of management consultancy-driven shareholder value-oriented reforms in corporations, while heavy on rhetoric, have tended to be rather light on actual reform. Rather, once we push past the construction of new forms of story to tell market actors, shareholder value strategies appear to be little more than "a good deal of tautology combined with a fairly traditional 1980s concept of strategy".[52] What the shareholder value rhetoric *is* good at, however, is the production of short-term bounces as firms are seen to be intensifying their focus on shareholder value through the ostentatious adoption of new strategies or, indeed, new boards and CEOs.[53]

Whose efficiency ought we to privilege? As Williams points out, drawing from Lazonick and O'Sullivan, through the 1970s, "most US corporations retained and reinvested earnings which provided the economic dynamic behind broadly based prosperity". Since the 1980s,

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47 Hansmann and Kraakman, "The end of history", n. 6 above, p. 442; A Keay, "Ascertaining the corporate objective: an entity maximisation and sustainability model" (2008) 71 *Modern Law Review* 668.

48 See R Ball, "What do we know about stock market 'efficiency'?", unpublished manuscript (University of Rochester: William E Simon Graduate School of Business Administration, Managerial Economics Research Center 1989).

49 Keay, "Ascertaining the corporate objective", n. 47 above, p. 670; e.g. on possible conflicts between institutional and other investors, see T Woidtke, "Agents watching agents? Evidence from pension fund ownership and firm value" (2002) 63 *Journal of Financial Economics* 99–131; Anabtawi, "Some skepticism", n. 41 above.

50 Sundaram and Inkpen, "The corporate objective revisited", n. 23 above, p. 355.

51 Macey, "Economic analysis", n. 23 above, p. 36.

52 Froud et al., *Financialization and Strategy*, n. 4 above, p. 47.

53 For one story of a market spectacle-driven search for new leadership, see R Khurana, *Searching for a Corporate Savior: The irrational quest for charismatic CEOs* (Princeton NJ: Princeton UP 2002), pp. 1–19.

however, "there has been a 'transformation of US corporate strategy' around the principles of downsizing the corporate labour-force and distributing earnings to shareholders".[54] Why, rather than adopting an efficiency rule where directors would "maximize the sum of all the risk-adjusted returns enjoyed by all of the groups that participate in firms",[55] would shareholder value be privileged? Part of the answer must lie in the fact that shareholder value is not an efficiency maxim at all. Rather, it is a "a power relationship, that is a particular (societal) way to design a corporation".[56] Convergence on shareholder value is not a matter of convergence on efficiency. Claims about accountability are about these relationships, not about formal processes of agent-control. It is a set of political decisions as to how resources ought to be distributed in society. It is riven with value judgments and decisions, masquerading as neutral forces.[57]

Financialisation and financial crises

The three defences of shareholder value are worth taking seriously, given that they provide the backdrop to economic life in corporate economies. Moreover, they bring a focus on what precisely is meant in political and business parlance by corporate accountability. Nevertheless, they are neither empirically nor normatively sustainable in and of themselves. The normative dimension is in many ways the most important, given that accountability claims have always involved the construction of normative frames within which people ought to work. That is, the appeal to accountability is never merely a matter of brute force nor a matter of simple expediency. It is a plea for a certain claim to power over (in this case) the company to be honoured by society at large. Or, to put it differently, accountability is a "second-person standpoint", that occurs within and helps sustain or transform a moral community.[58]

Furthermore, we have to understand the manner in which the shareholder value claim, and myriad specific claims that follow from it, has sought to reconfigure the moral community in line with the opportunities provided by the technical and regulatory innovations behind the financialisation of corporate economies and corporate governance. It goes without saying that managerial appropriation is scarcely new. As Lawrence Mitchell and Paddy Ireland point out, large industrial corporations, in both the United Kingdom and the United States, originated in large part from the desire of proposers to extract investment and speculative capital from a growing class of investors. Industry, in these terms, is carried on, not for the sake of production, but "for the sake of business",[59] or, to be more precise, the business of market accumulation.

Primary among the features of financialised capitalism is the hyper-innovative character of the markets, driven by "the growth in the liquidity of capital markets, expressing increases in the breakdown and transfer of risks", and by "the upsurge, in these same markets, of

54 Williams, "From shareholder value", n. 4 above, pp. 3–4.

55 Stout, "Bad and not-so-bad", n. 8 above, p. 1198.

56 A Rebérioux, "European style of corporate governance at the crossroads" (2002) 40 *Journal of Common Market Studies* 119.

57 See G M Frankfurter and E G McGoun, "Ideology and the theory of financial economics" (1999) 39 *Journal of Economic Behavior & Organization* 159–77.

58 See Darwall, *The Second-person Standpoint*, n. 3 above; C O'Kelly, "A political theory of accountability" in M Dubnick and H G Frederickson (eds), *Accountability and its Promises* (New York: M E Sharpe 2009).

59 Mitchell, *The Speculation Economy*, n. 19 above, p. 13; Ireland, "Capitalism", n. 18 above; P Ireland, "History, critical legal studies and the mysterious disappearance of capitalism" (2002) 65 *Modern Law Review* 106–19; Ireland, "Company law", n. 25 above.

investment funds, responsible for the management of continually increasing savings"[60] and, finally, the "mass-marketing of financial products to consumers".[61] Financialised capitalism, "oozing with instability",[62] has not seen the democratisation of capital but the capitalisation of savings through institutional investors, driving a systematic reliance "on the constant searching out, or the construction of, new asset streams, usually through a process of aggregation, which then – and only then – allows speculation to take place".[63]

This hyper-innovative system is combined with the enlisting of internal and external gatekeepers and financial intermediaries through a dense network of fees and bonuses. While these are designed to incentivise individual behaviour, massive hazards emerge in terms of risks that resources would be appropriated as everyone is brought inside the financial flow. The notions upon which agency theory is based – gatekeeping, governance and private regulation – all break down.[64] Instead, innovation takes on a life of its own when intermediaries develop "a stake in an economy of permanent restructuring", beyond the production of value "because deals (be it acquisition or demerger, new issues or buybacks, securitization or rebundling risks) are the source of fees".[65] In fact, the amounts of money circulating through financial and equity markets far exceeds those circulating through the "real" economy.[66]

Enron

Enron holds a totemic place in the development of this process. Enron was, in hindsight, the quintessential financialised company of the new millennium. Enron's self-consumption occurred in the midst of an incredibly complicated set of financial arrangements as the company first attempted literally to transform itself into a set of markets and then as managers, with lucrative collaboration from gatekeepers,[67] set about appropriating the company's resources. The key to Enron's success was that it could financialise infrastructural products like electricity, gas or broadband. By constructing market instruments in these products, Enron hoped to collect at both ends, so to speak. The company would not only trade in the products, but would collect a fee for each trade that third parties made on their market. Enron's executives were aggressive in their pursuit of relationships with auditors, ratings agencies and banks, all of whom made vast profits from

60 Aglietta and Rebérioux, *Corporate Governance Adrift*, n. 4 above, p. 1; See Froud et al., "New actors", n. 4 above, pp. 339–40; A Leyshon and N Thrift, "The capitalization of almost everything" (2007) 24 *Theory, Culture & Society* 97–115.

61 Froud et al., "New actors", n. 4 above, p. 340.

62 Aglietta and Rebérioux, *Corporate Governance Adrift*, n. 4 above, p. 183.

63 See also Leyshon and Thrift, "The capitalization", n. 60 above, p. 98; the risks of financialisation were pointed to as early as the mid-1980s by the Committee on the Global Financial System, *Recent Innovations in International Banking* (The Cross Report) (Geneva: Bank for International Settlements, CGFS Publications 1986), pp. 187ff.

64 See J Coffee, *Gatekeepers: The professions and corporate governance* (Oxford: OUP 2006).

65 P Folkman, J Froud, S Johal and K Williams, "Working for themselves? Capital market intermediaries and present day capitalism" (2007) 49 *Business History* 561; On compensation packages, see P Bolton, J Scheinkma and W Xiong, "Executive compensation and short-termist behaviour in speculative markets" (2006) 73 *Review of Economic Studies* 577–610.

66 R Dore, "Financialization of the global economy" (2008) 17 *Industrial and Corporate Change* 1097–112.

67 Indeed, Anderson, Enron's auditor, made millions from consultancy services aimed at assisting Enron's managers construct the sham special vehicles that Anderson ought to have exposed in the audit. See W Bratton, "Enron and the dark side of shareholder value" (2002) 76 *Tulane Law Review* 1350.

the provision of non-audit services, ratings on financial products and the construction of Byzantine financial manoeuvres. Its collapse followed as managers took reckless risks and strove to obscure huge losses as various speculative ventures went badly wrong.[68]

While the manner of Enron's death was ultimately conventional in many ways, in that the company added a variety of bad bets to existing bad debts,[69] the cause of its death lay with the sequence of financial bets that Enron made, the linking of its stock market value to its financialised products and, to a lesser extent, the appropriation of company assets by directors. Moreover, the directors' activities could not have been possible without gatekeepers' collaboration, itself facilitated by a network of fees and bonuses. Enron's directors, when the company was apparently successful, were aggressive in their manipulation of financial disclosure so as to present the most advantageous returns to the stock market. This in turn allowed the markets spectacularly to overvalue the company.

The political and media narratives at the time were that the Enron collapse was down to a need to make companies more "accountable to shareholders". However, this begs the question of whether Enron's capacity to get away with the confection of success it created was more a result of managers obscuring information or of many shareholders not being motivated to question that information in the first place? On the one hand, "one thing that did contribute", to the company's collapse "was Enron's willing embrace of the favorite governance 'reform' fad of the 1990s, stock options".[70] In one sense, Enron collapsed in an era when shareholders were already the focus. The problem was that that focus was simply a vehicle for appropriation on the part of the directors. The proper incentives were also perverse incentives.

Added to that, a concern for actual performance only matters to long-term investors if they either cannot exit or will not exit (in the case of people or institutions whose shareholding is motivated by considerations other than market values). In other cases, when the share is not treated as a fact of ownership but as a tradeable commodity and where the stakes in companies do not go beyond the sentiment of market players, a corporation's reputation for success will continue until the point when uncritical sentiments about the stock, driving bids higher and higher, are replaced by deflation as demand slumps and those at the top of the pyramid are left with losses. The important thing for the investor is not to be the left carrying the can when the slump hits.

It seems, however, that the Enron and other collapses in 2001–02 were harbingers of

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68 Bratton, "Enron", n. 67 above; H Butler and L Ribstein, *The Sarbanes-Oxley Debacle: How to fix it and what we've learned* (Washington DC: American Enterprise Institute 2006); S Deakin and S Konzelmann, "Learning from Enron" (2004) 12 *Corporate Governance: An international review* 134–42; J Gordon, "What Enron means for the management and control of the modern business corporation: some initial reflections" (2002) 69 *University of Chicago Law Review* 1233–50; P M Healy and K G Palepu, "The fall of Enron" (2003) 17 *Journal of Economic Perspectives* 3–26; D Kershaw, "Waiting for Enron: the unstable equilibrium of auditor independence regulation" (2006) 33 *Journal of Law and Society* 388–420; M Klock, "Two possible answers to the Enron experience: will it be regulation of fortune tellers or rebirth of secondary liability?" (2002) 28 *Journal of Corporation Law* 69–109; Coffee, *Gatekeepers*, n. 64 above; for a series of journalistic accounts, see B Cruver, *Enron: Anatomy of greed – the unshredded truth from an Enron insider* new edn (London: Arrow Books 2003); P Elkind and B McLean, *The Smartest Guys in the Room: The amazing rise and scandalous fall of Enron* new edn (Harmondsworth: Penguin 2004); P C Fusaro and R Miller, *What Went Wrong at Enron* (Chichester: John Wiley & Sons 2002); see also special issues on Enron in "Symposium: Enron" (2002) 35 *Connecticut Law Review* 915–1254; "Symposium: lessons from Enron, how did corporate and securities law fail" (2003) 48 *Villanova Law Review* 989–1280.

69 D Langevoort, "The organizational psychology of hyper-competition: corporate irresponsibility and the lessons of Enron" (2002) 70 *George Washington Law Review* 974.

70 Stout, "The mythical benefits", n. 15 above, p. 808.

the greater crisis that hit Anglo-American capitalism in 2007. While immediately caused by a property bubble, and thus fitting in with a long line of financial crashes,[71] as I said in the introduction, the financial crisis was down to corporate governance: to structures endogenous to the corporate form itself. The range of incentives available to executives and to intermediaries and the ceding of oversight power to financial markets led to the pursuit of highly risky but spectacular products that, through the externalising of risk, produced illusory liquidity for the financial services sector. The problem was not about bad decisions in and of themselves. It was about the development of a system that *required* bad decisions. To pursue the safe path would have been to lose favour with the markets and, ultimately, to lose one's position. In these circumstances, financialisation means that the founding conflict between principals and agents, upon which agency theory is based, simply disappears.

While "the tradability of securities and the liquidity of markets allow firms to escape the sphere of ownership",[72] the share has been placed in a pre-eminent position in corporate governance. This shift has led to the birth of what might be called the postmodern corporate form, where totemic information takes the form of news that will lead to positive share movements. Increasingly volatile markets are as prone to spectacles, such as the introduction of new CEOs or innovative though risky financial investments that exploit "stock market crazes",[73] as they are to actual production. Moreover, market actors have relied on, or simulate a reliance on, verification from gatekeepers that are themselves deeply implicated in the fees structures surrounding new products.

While it is possible that share price movements might be related to increases in production or revenue or profit, it is by no means necessary that this would be the case. Information might be produced through corporate governance reform, but it might just as well be produced through reforms to the means by which information is conveyed, by focusing on the short-term to the detriment of long-term value creation, or simply by paying homage to the important norms of shareholder value. These all involve management of shares rather than of companies in the sense that the corporation is reconfigured so that its function is the production of information for dissemination to stock markets.

Conclusion: back to accountability

It would also be wrong to say that the corporate economy and the corporate form has been entirely unsuccessful in reconfiguring moral communities around shareholder value, at least when it comes to the community of corporate and economic elites. The key has been for the discourse of this community to be extended and accepted in society at large. In these terms, the most important role of shareholder value in the context of financialisation and the postmodern company has been to expand the influence of the shareholder value story beyond the moral sub-community within which it might best resonate. The accountability story at the root of shareholder value has also been very successful in insulating the company from external scrutiny and control. The processes and procedures put in place, while expanding the sphere of accountability, and while displaying more publicity than has ever existed before in economic vehicles, has actually served to close down external scrutiny, both by giving the appearance of a self-regulatory system (and thus an argument against external regulation) and by actually obscuring wrongdoing.[74] Accountability, in these terms,

71 As described by Kindleberger and Aliber, *Manias, Panics and Crashes*, n. 1 above.

72 Aglietta and Rebérioux, *Corporate Governance Adrift*, n. 4 above, p. 264.

73 Ibid., p. 97.

74 For a discussion of these perils in accountability, see R Mulgan, "'Accountability': an ever-expanding concept?" (2000) 78 *Public Administration* 555–73.

is less about delegated control and more about the struggle to both dominate a social (in this case corporate) sphere and to insulate it from other stakeholders.

Claims about accountability are, in these circumstances, claims about politics. They are claims about the terms of virtue in a given society: how that society ought to be organised. When appeals are made to the wider norms of moral communities, the normative core of an accountability discourse is rendered testable. Normative claims are made in the form of empirical claims.

My aim in this paper is not to argue that the shareholder value paradigm as a rallying point for corporate governance is at an end. As Brian Cheffins has pointed out regarding the UK's legal structures, it is very likely here to stay.[75] What has changed, however, is the idea of shareholder value as a defensible ideal for corporate governance, at least in the context of wider social norms. Shareholder value is now a convention in search of a justification as the fiction of rational market efficiency dies a death that has turned out to be painful far beyond the boundaries of the company.

75 Cheffins, *Corporate Ownership*, n. 34 above, pp. 401ff.

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Non-executive directors and corporate governance

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The focus of this contribution is on corporate governance and corporate boards in the public, for profit, sector, in particular the role of non-executive or outsider directors, and the ideas of accountability under which it is presumed they operate. However, the message of the paper is wider than this. Given the nature of corporate power in the global context, ensuring accurate and trustworthy corporate governance is a broader issue than simply one that concerns individual shareholders or nation-state-level economic policy.[1] The world's largest corporations have turnovers in excess of the GDP of many individual states and have a transworld presence in the sense that their market listing is not confined to one nationally based exchange. At the domestic level, there is an argument to be made that corporations are not any longer private actors. They are public actors in terms of power and influence in areas such as environmental impact, location and relocation decisions, and corporate social responsibility.

The most popular and pervasive model of corporate regulation sees the shareholders of the corporation as those most in need of the protection of good governance. This model naturally emphasises the private nature of the corporation and its governance structure. Its dominance means that it makes sense to accept this model for the purposes of this paper, although it is possible to find vigorous condemnation of it among UK and US commentators[2] for its concentration on financial performance, short-term profits and its neglect of wider interests. Taking just two points of qualification should make it clear that governance failure has consequences wider than the official model would lead us to believe. The first is that the rise of defined contribution pension plans in the UK and the US makes many employees interested parties in corporate governance through the medium of institutional investment. They are literally arms-length investors, for their financial wellbeing post-retirement depends on favourable market returns on their personal retirement investment plan. The second is that a key function of boards of directors is the monitoring of the strategic direction of the corporation's business model and its risk management contingency. Should these functions and the monitoring of them not be exercised properly, it is likely that the pool of those looking for accountability will be wider than simply shareholders. Fannie Mae and Freddie Mac in a US context and Northern Rock in a UK

1 M Huse "Renewing management and governance: new paradigms of governance?" (2003) 7 *J of Man and Gov* 211–21.

2 L Mitchell, *Progressive Corporate Law* (Boulder, Colorado: Westview Press 1995).

context demonstrate this nicely. The idea that governance failure in a corporate sense is not always driven by fraud is a point to which I return later in this contribution. All of these issues make the executive management of the corporation an issue wider than simply the mechanics of private governance.

Boards of directors are "the apex of the internal control system"[3] of the corporation. The official narrative in Anglo-American corporate law is that directors are appointed by shareholders and are the representatives of shareholders, or owners. Corporate boards are responsible for devising and/or revising corporate strategy, ensuring that management operates effectively in the interests of shareholders, setting performance incentives for managers, appointing, monitoring and if necessary removing the chief executive officer (CEO). Outside or non-executive directors form a second layer, if you like, within the board itself to watch over executive directors who are doing these things. The reality is that the appointment of directors, both executive and non-executive, is approved by the shareholders without, in the overwhelming majority of cases, any discussion. The board in many ways is a self-perpetuating oligarchy. Its existing members put up new members for election and re-election. Shareholders do not interview directors and rarely even look at their curricula vitae to determine their suitability. These things are done by existing board members who "market" the suitability of new appointees to the shareholders.[4] Directorships are rarely contested. While the recent example of Yahoo! and Microsoft provides a different story to this, its news value lies in its novelty and hence helps to distinguish between official and realist narratives.

The strategic and managing function of directors sits alongside the structural requirements of the regulatory framework in which the corporation operates, although both the US and UK are characterised in the main not by specific regulatory demands but by broad regulatory directives which the corporation, through its directors and managers, absorbs and interprets into internal structures.[5] That said, however, the UK exhibits this approach on a larger scale than the US. The UK experienced huge corporate collapses that were thought to be due to poor governance rather than market conditions in the last fifteen years of the last century; the examples of BCCI, Polly Peck and the Maxwell empire spring to mind. There was also an outbreak of executive salary increases which were thought to be "excessive", particularly as they often seemed to concern the executive leadership of recently privatised formerly publicly owned utilities. The UK, rooted in a principles rather than rules culture,[6] established a tradition of dealing with pressures on the corporate system by holding a private inquiry, led by a "City" figure,[7] leading to the publication of a voluntary regulatory code supported by the listing authority. This means that corporations that do not either follow the voluntary code or explain why they are not following it will be denied a listing on the London Stock Exchange. The City figure for the first such inquiry was Sir Adrian Cadbury, the recently retired chair of the then FTSE 100 company Cadbury Schweppes plc, a director of the Bank of England and of IBM. Subsequent inquiry chairs

3 M Jensen and W Meckling "Theory of the firm: managerial behaviour, agency costs, and ownership structure" 3 *J Fin Econ* (1976) 305–60.

4 G F Davis and G E Robbins, "Nothing but net? Networks and status in corporate governance" in K Knorr-Cetina and A Preda (eds), *The Sociology of Financial Markets* (Oxford: OUP 2004), pp. 290–311, at p. 292.

5 L Edelman, "Legal environments and organizational governance: the expansion of due process in the American workplace" (1990) 95 *Am J Soc* 1401–40.

6 D Kershaw, "Evading Enron: taking principles too seriously in accounting regulation" (2005) 68 *Modern Law Review* 594–625.

7 I Jones and M Pollitt, "Who influences debates in business ethics? An investigation into the development of corporate governance in the UK since 1990" in I Jones and M Pollitt (eds), *Understanding How Issues in Business Ethics Develop* (Basingstoke: Palgrave Macmillan 2002), pp. 14–66.

have been equally illustrious figures within the City of London, as my comments about Derek Higgs below demonstrate. The importance of elites and the social capital they generate is something that I return to later in this contribution.

The Code appears as a series of "Main Principles" with "Supporting Principles". The philosophy of the Code is that corporations should "comply or explain", that is, either comply with the code or offer reasons for non-compliance, made public through the channels of corporate reporting, leaving the market to decide on the appropriateness of any non-compliance. This philosophy has developed since 1992 into one where the nature of compliance with Main Principles has to be explained while an indication of whether there is compliance or explained non-compliance with Supporting Principles has to be given. What this means in effect is that shareholders, through the disclosure mechanism, can decide if the measures set out as constituting compliance with Main Principles meet with their approval. Likewise if non-compliance with Supporting Principles is announced, the shareholders will decide on whether they approve of the corporation's decision not to comply for the reasons it gives, by either selling their shares – resulting in a share-price drop – or keeping their shares – resulting in price stability.[8] A recent example is provided by the governance changes at Marks & Spencer plc. A key component of the Cadbury Report, or Cadbury Code as it became, was the separation of the function of chair and chief executive.[9] These positions, it recommended, should be held by different members of the board of directors. The Higgs Report of 2003[10] expressed this view with considerably more vigour and the Combined Codes[11] of 2003, 2006 and 2008 enshrined this in Principle A.2.1.

In March 2008, Marks & Spencer plc, a long-established FTSE 100 company, announced that upon the retirement of its current chair later that year the position would be filled by its current chief executive who would then hold both jobs until his scheduled retirement in 2011. Shareholders were issued with individual letters explaining the background to and the reasons for the decision, which amounted to an admission that the corporation had been guilty of succession planning failure and that no insider was ready to take on the job and bringing in an outsider was thought to be too disruptive. The immediate reaction of the market, assessed by share-price change, was indifference; the share price dropped 3 pence in that day's trading. At the actual shareholders' meeting some months later in July 2008, holders of 22 per cent of the company's equity voted against or abstained from the resolution to appoint the chief executive as chair. This was accompanied by a share-price drop of 25 per cent, but also, at the same time, an unexpected profits warning. In August 2008, the share price had recovered some of this loss and was on a roughly upward trajectory, despite holding its listing in a steadily dropping exchange during this time. So, we can deduce from this that either the market is not as responsive to governance issues as those who drafted these *ex ante* principles thought that it would be or that the market generally did not disapprove of the governance change so much as to use the exit option of share sale, despite exercise of the voice option in relation to the shareholders' meeting.[12] Despite the importance attached to the separation of these roles within the Cadbury Report

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8 I MacNeil and X Li, "'Comply or explain': market discipline and non-compliance with the Combined Code" (2006)14 *Corporate Governance* 486–96.

9 *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report) (London: Gee & Co. December 1992), para. 4.9.

10 *Review of the Role and Effectiveness of Non-executive Directors* (Higgs Report) (London: DTI January 2003).

11 Combined Code, www.frc.org.uk/corporate/combinedcode.cfm.

12 A Shabbir and C Padgett, "The UK Code of Corporate Governance: link between compliance and firm performance" (2008), www.som.cranfield.ac.uk/som/research/researchpapers.asp.

and from practitioner comments,[13] there is no empirical evidence to the effect that this sort of structural independence produces results in terms of improved financial performance,[14] although it does seem to be the case that the overwhelming majority of listed companies complied with the Code on this point soon after its inception.[15]

The net result of these inquiries has been an enhanced role for independent (or, as they are termed in the UK, non-executive directors), greater accounting disclosure and instructions to the corporate sector to improve its communications with its larger institutional shareholders. This model of governance, with professional board members directing and producing strategy but held in check by the addition of lay members, has, in the context of the UK, become a very popular method of governance. It is the preferred method of governance for organisations as diverse as hospital trusts, judicial appointments and school governing boards. It is seen as the mechanism for ensuring compliance and probity for a distant public. In the context of the corporation, this form of governance can be seen as embodying the classic law and economics approach to corporate regulation.[16] Regulation is enabling, rather than mandatory, and ultimate judgment on the structures adopted is exercised by the financial market. Shareholder value is maximised through the adoption of efficient structures that both police the behaviour of potentially errant managers – errant in the sense that they might indulge in "shirking" or other "opportunistic behaviour" at the expense of shareholders[17] – and ensure that accurate and sufficient information is relayed to shareholders – otherwise described as the principal and agent approach.[18] The only suggestion that the contractarian approach is not on its own able to tell the story of corporate governance is the recourse to a City figure to produce the voluntary code. In essence, a system of accountability based around an impersonal financial market could not be imposed without acknowledging that the corporate sector is embedded in social relationships and social networks, in fact no system could be imposed without acknowledging this. This system of governance had to be created and endorsed as appropriate by an insider if it was to gain traction. Participants in governance are discriminating about whom they acknowledge as a relevant and meaningful insider in any particular context.[19] The Higgs Report, the final report in this list, to which I turn next, is an exemplar of this need to acknowledge the power of social and political context. Higgs was an executive director of an FT 100-listed corporation, a non-executive director of a large plc and an institutional director.[20]

A succession of reports, recommendations and statements of best practice have followed the initial report, compiled under the auspices of self-regulation, each seeking to improve the standards of corporate governance generally and mechanisms for setting

13 J Keenan, "Corporate governance in UK/USA boardrooms" (2004) 12 *Corporate Governance* 172.

14 C Dalton and D Dalton, "Boards of directors: utilizing empirical evidence in developing practical prescriptions" (2005) 16 *British Journal of Management* S91–7.

15 MacNeil and Li, "Comply or explain", n. 8 above.

16 A Shleifer and R Vishny, "A survey of corporate governance" (1997) 52 *J of Finance* 737–80.

17 O Williamson, *The Economic Institutions of Capitalism* (New York: Free Press 1985).

18 E Fama, "Agency problems and the theory of the firm" (1980) 88 *J Pol Econ* 288–307; E Fama and M Jensen, "Separation of ownership and control" (1983) 26 *J L and Econ* 301–25.

19 G F Davis and H R Greve, "Corporate elite networks and governance changes in the 1980s" (1997) 103 *Am J Soc* 1–37.

20 Higgs Report, n. 10 above; I Jones and M Pollitt, "Understanding how issues in corporate governance develop: Cadbury Report to Higgs Review" (2004) 12 *Corporate Governance* 162–71, at p. 164.

directors' remuneration, specifically, for the benefit of shareholders.[21] Taken together these codes are now known as the Combined Code the latest iteration of which was in June 2008.[22] When a corporation releases its statement of compliance or explained non-compliance, it is doing so against the principles and supporting principles of the 2008 Combined Code. The Higgs Report[23] was the last in the series of reports that make up the Combined Code and is the main focus of attention in this contribution. It was commissioned by the UK Government specifically to look at how corporate governance in the UK could be strengthened in the wake of the Enron, WorldCom and Tyco failures and scandals in the US. The Higgs Report, then, was proactive in a UK context but also reactive in the sense that it was a direct response to the Sarbanes-Oxley legislation in the US. The brief of the Higgs Report was to look at outsider directors; their identity, their independence, their effectiveness. The first iteration of the voluntary code on corporate governance, the Cadbury Report, had handed a key monitoring role in corporate governance to outsider directors. The Higgs Report was the first time in over ten years that the role of this group had been subjected to serious examination. The decision to look at outsider/non-executive directors was no doubt inspired by the view that they and their independence were thought to be significant in the failure of Enron. Enron looked to have a largely independent board with only two of its directors occupying executive positions within the corporation. However, when industry ties and other factors such as charitable donations were factored in, the board had 43 per cent independent directors as opposed to 72 per cent in its peer corporations and 63 per cent for investment banks.[24] The results of the Higgs Report, after much debate, were amendments to the voluntary code that included: a requirement that outsider directors make up a significant part of the board – the actual phraseology is that there should be a "balance of executive and non-executive directors . . . such that no individual or small group of individuals can dominate the board's decision taking";[25] that letters of appointment of non-executive directors were made available through corporate reporting mechanisms (so that shareholders would be able to see the terms on which they had been appointed to the board and for how long); a definition of independence from the board for outsider directors, and a requirement that outsider directors be declared to be independent or not and, if so, on what grounds their independence was asserted; a designation of one of the outsider directors as the senior director; and an identification of one of the outsider directors as being the communication conduit between investors and the board.

Given that each review of corporate governance has been in the shadow of an actual or feared failure of governance, it is hardly surprising that the thrust of these recommendations should be towards monitoring and control of executive directors by non-executive directors through structural reforms for the benefit of distant shareholders. The test for code amendments is colloquially known as the "Maxwell test" – will this stop another Maxwell? By way of explanation for the uninitiated, the now-deceased Robert Maxwell provides the complete antithesis of the City figures used to suggest and endorse corporate governance codes and amendments to them. He did not come from an established family business background, as part of the East-European Jewish diaspora, he

21 Cadbury Report, n. 9 above; *Directors' Remuneration* (Greenbury Report) (London: Gee & Co. July 1995); *Committee on Corporate Governance* (Hampel Report) (London: Gee & Co. April 1998); *Internal Control: Guidance for directors on the Combined Code* (Turnbull Report) (London: ICAEW 1999).

22 See Combined Code, n. 11 above.

23 See Higgs Report, n. 10 above.

24 S Gillan and J Martin, "Corporate governance post-Enron: effective reforms or closing the stable door" (2007) 13 *Journal of Corporate Finance* 929–58.

25 Main Principle A.3, see Combined Code, n. 11 above.

was not British by birth and compounded these disadvantages by both serving as a Labour Member of Parliament and remaining a Labour Party activist. He was an outsider in every sense of the word. He had been the subject of a Department of Trade and Industry investigation in the early 1970s which had resulted in the department declaring that he was an unsuitable person to be involved in the running of a public company. Later in his business career he was found to have used the pension funds of several of his companies to purchase shares in one of his own corporations to prop up its share price. The result was a huge corporate collapse and the personal bankruptcy of several family members.

The volatile nature of markets and the boom and bust cycles which it seems are endemic to capitalism means that each new set of *ex ante* rules is set up with the last high-profile business failure or scandal in mind. Failure is not always the result of dishonesty, and perhaps this is the problem with the Maxwell test. Northern Rock is a good example of the environment external to the business itself changing and so putting pressure on what had been seen as a successful and innovative business model previously. While there was no suggestion of dishonesty or sharp practice in Northern Rock, the Treasury Select Committee found that:

> The non-executive members of the board, and in particular the chairman of the board, the chairman of the risk committee and the senior non-executive director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members.[26]

While this was a failure of the non-executive, the failure to ensure that the UK's biggest mortgage lender had a chief executive with a banking qualification was the failure of the Financial Services Authority, the relevant financial regulator. So, in some senses the watchers watching the watchers have failed their first real test post-Higgs. What is lauded in boom times as creative accounting and innovation becomes in recession the latest loophole to be closed.[27] Corporate success is often founded on the use of practices which take compliance with governance regimes to their limit and governance changes merely result in new devices being created.[28] Corporate governance regimes, then, are linked less to performance measurement and more to the policing of periodic market crises. The terms of each intervention in corporate governance are not strictly *ex ante* as they are dealing with *ex post* events. Despite the UK approach of general principles and flexibility as to how the principles are adopted or even if they are to be adopted, the emphasis is still on structural change as a way of creating better governance. The most important tasks that non-executive directors are charged with are overseeing the setting of incentives for managers (executive pay in other words), appointing and if necessary removing the chief executive or other non-performing executives, and assessing strategy and performance of the corporation. This last task is of course also the task of executive directors so ostensibly this creates a double layer of protection for shareholders.

The seriousness with which these Code reforms are made should not be underestimated. The UK financial sector needed to be able to convince the US Securities and Exchange Commission in particular, that the requirements of its corporate governance code were as strict as those imposed on US listed corporations courtesy of the Sarbanes-Oxley legislation, in order to soften the legislative impact on those UK-based firms that had a cross-listing in the US. Higgs himself said in an interview with the *Daily Telegraph* in

26 Treasury Select Committee session 2007–2008, *5th Report: The Run on the Rock*, 24 January 2008.

27 T Clarke, "Cycles of crisis and regulation: the enduring agency and stewardship problems of corporate governance" (2004) 12 *Corporate Governance* 153–61.

28 D McBarnet and C Whelan, *Creative Accounting and the Cross-Eyed Javelin* (New York: Wiley 1999).

January 2003: "We want to raise the bar for performance from corporate boardrooms and blow away the last vestiges of perhaps how things were a few decades ago when it was all a bit cosy, a bit familiar, a bit Christmas-ornamenty." So, legitimate questions to ask are: how likely is this sort of double-layered accountability to "raise the bar for performance"; and what is meant by "performance"? Perhaps unsurprisingly, given the nature of the pervasive corporate governance model, this second question can be answered rather more easily than the first – performance is financial performance measured in terms of profit levels and dividend declarations for shareholders.[29] Agency theorists are unable to agree on whether the presence of outside directors does or does not improve a corporation's financial performance. There are a number of studies which provide conflicting conclusions. For example, Baysinger and Butler[30] find that it might have a "mild effect", Kesner[31] asserts that it has no effect (although Kesner's primary agenda was to look at questions of gender and board diversity within board committees rather than specifically examining financial performance) and Dalton et al.[32] use meta-analysis of fifty-four studies of board composition and thirty-one studies of board leadership structure to conclude that there is little evidence of a link between a corporation's governance structure and its financial performance. Conflicting empirically based accounts about the effect of the presence of non-executive or outside directors occur throughout the literature on takeover defences, the composition of board committees, executive composition and removal of the chief executive.[33] The equivocal findings in these areas tell us something about using agency theory to explain board behaviour. Agency theory can only look at the structural components of board composition and then only judge them against its assumptions about what motivates opportunistic behaviour[34] and its rather one dimensional picture of human nature.[35] This could then take us into the literature on the failings of agency theory. However, there are plenty of reviews of this elsewhere.[36] It is also the case, however, that once we move away from the formulistic approach to board behaviour and firm performance offered by agency theory then the "outsider director as the ultimate watcher" model starts to come under considerable pressure. If we are only testing the presence of outside directors against fixed variables, such as the presence or absence of shareholder litigation,[37] for example, then more nuanced questions about role, behaviour and perceptions of status are not on the agenda.

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29 S Bhagat and B Bolton, "Corporate governance and firm performance" (2008) 14 *Journal of Corporate Finance* 257–73.

30 B Baysinger and H Butler, "Corporate governance and the board of directors: performance effects of changes in board composition" (1985) 1 *Journal of Law, Economics and Organization* 101–34.

31 I Kesner, "Directors' characteristics and committee membership: an investigation of type, occupation, tenure and gender" (1987) 31 *Acad of Management Journal* 66–84.

32 C Dalton, C M Daily, A E Ellstrand and J L Johnson, "Meta-analytic review of board composition, leadership structure and financial performance" (1998) 19 *Strategic Management Journal* 269–90.

33 See, generally, I Filatotchev, G Jackson, H Gospel and D Allcock, *Key Drivers of "Good" Corporate Governance and the Appropriateness of UK Policy Responses* (London: Department of Trade and Industry 2007).

34 J Davis, F D Schoorman and L Donaldson, "Towards a stewardship theory of management" (1997) 22 *Academy of Management Review* 20–47.

35 C Daily, D R Dalton and A A Cannella, "Corporate governance: decades of dialogue and data" (2003) 28 *Academy of Management Review* 371–82.

36 D Anderson, S J Melanson and J Maly, "The evolution of corporate governance: power redistribution brings boards to life" (2007) 15 *Corporate Governance* 780–97; G F Davis, "New directions in corporate governance" (2005) 31 *Annual Rev of Soc* 143–62.

37 I Kesner and R Johnson, "An investigation of the relationship between board composition and stockholder suits" (1990) 29 *Strategic Management J* 327–36.

To make any judgment about the strategy and performance assessment role of outsider directors we need to look at a wider picture.[38] This takes us into the realm of stewardship theory and resource dependency theory and to the last (but I think the most significant) part of this paper, the potential effect of the presence of elites and networks. We need to open the black box of the board room[39] and think about the sort of issues that arise when the shareholders' original watchers – executive directors – are themselves being watched by outsider directors. The key questions would appear to circle around power, influence, independence and trust. These issues have to be negotiated within the boardroom itself if the individuals there are to be able to function as a unit. If this is achieved, then the next question has to be: what effect does this successful negotiation have on the accountability function of non-executive directors? Or, in other words, can distant accountability be maintained in the presence of a locally negotiated functionality?

The extract from the first Principle of the Code below makes it clear that outside directors are required to engage with and endorse corporate strategy in addition to their monitoring of performance and remuneration. This makes sense in its operational context as it is hard to see how any meaningful monitoring of performance etc. could take place without a reasonably detailed understanding of the corporation's market position, product placement and expansion strategies. However, the explicit rendition of performance review and endorsement of strategy makes it clear that there has been a considerable expansion of what can be termed internal service tasks.[40]

> **A.1 The Board**
>
> **Main Principle**
>
> Every company should be headed by an effective board, which is collectively responsible for the success of the company.
>
> **Supporting Principles**
>
> The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met . . .
>
> As part of their role . . . non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.

38 K Eisenhardt, "Agency theory: a review and assessment" (1989)14 *Academy of Management Review* 57–74.

39 R Leblanc and M Schwartz, "The black box of board process: gaining access to a difficult subject" (2007) 15 *Corporate Governance* 843–51; A Pettigrew, "On studying managerial elites" (1992) 13 *Strategic Management Journal* 163–82.

40 P Bezemer, G F Maassen, F A J Van den Bosch and H W Volberda, "Investigating the development of internal and external service tasks of non-executive directors: the case of the Netherlands (1997–2005)" (2007) 15 *Corporate Governance* 1119–29.

In order to be able to provide the sort of input that the Code requires, outside directors must be able to display an awareness of how business works and be able to assimilate quickly information about how the particular business works. They need to be able to understand the dynamics between executive directors. They need to understand how individual strategic decisions will impact on share price and how strategy is formulated within the organisation and then packaged to those outside the organisation.[41] They need to be able to display sufficient knowledge in these areas to garner the trust of executive directors, thus enabling their comments and views to have an effect, and yet they need to maintain a sufficient distance such as to avoid capture by executive directors and remain independent. Obviously, they will be influenced by executive voices around them but not dwarfed by that influence. Trust is a two-way process, as outside directors have to feel able to rely on the extent and quality of information they are given by executive directors in order to perform their monitoring function.[42] Distrust between the two groups splits the board and results in a "circle of control and counter control".[43] Outside directors are nominated by the board for a five-year term initially and, if they wish to be reappointed, then they need to be considered effective and not divisive or undermining of their executive counterparts. Shareholders need to feel that the outside directors have sufficient influence within the board dynamic such that they can get their voice heard. The black box of management process is gradually being opened by empirical work looking at the dynamics of board relationships.[44]

The Higgs Report itself commissioned a piece of research from academics steeped in management process research.[45] Their task was to interview corporate chairs and non-executive directors to ascertain how they conducted the tasks listed above. The results of this research make fascinating reading. It tells the story of combining control and collaboration in a dialogue that the authors see as creating accountability, setting up intelligent accountability in place of distant accountability. Roberts (one of the authors of the Higgs research) describes in a different context what takes place as the "socializing forms of accountability".[46] This form of accountability occurs when two conditions are met: where there is frequent face-to-face contact between people and where there is no (or relatively no) power differential between the participants. It seems that what actually occurs in board processes is a non-defensive form of local accountability – so what non-executive director activities are doing is ensuring that board processes give rise to reciprocal understanding and dialogue rather than box-checking.

Intelligent accountability, or socialising forms of accountability, may well describe the changes in governance practice that are taking place in the post-Higgs era of boardroom discussions, but what they seem not to acknowledge is that this form of adaption is unlikely to take place without being enmeshed in an elite network that in social capital terms and

41 P Stiles, "The impact of boards on strategy: an empirical examination" (2001) 38 *J of Man Studies* 627–50.

42 R Hooghiemstra and J van Manen, "The independence paradox: (im)possibilities facing non-executive directors in the Netherlands" (2004) 12 *Corporate Governance* 314–24.

43 P Daudi, *Power in the Organisation* (Oxford: Blackwell 1986).

44 A Pettigrew and T McNulty, "Power and influence in and around the boardroom" (1995) 48 *Human Relations* 845–73; D Forbes and F Milliken, "Cognition and corporate governance: understanding boards of directors as strategic decision-making groups" (1999) 24 *Academy of Management Review* 489–505; T McNulty and A Pettigrew, "Strategists on the board" (1999) 20 *Organization Studies* 47–74.

45 T McNulty, J Roberts and P Stiles, *Creating Accountability within the Board: The work of the effective non-executive* (London: DTI 2003); J Roberts, T McNulty and P Stiles, "Beyond agency conceptions of the work of the non-executive director: creating accountability in the boardroom" (2005) 16 *Brit J of Management* S5–S26.

46 J Roberts, "Trust and control in Anglo-American systems of corporate governance: the individualising and socializing effects of processes of accountability" (2001) *Human Relations* 1547–72, at 1554–5, 1567.

network terms encompasses both executive and non-executive directors. The test of independence within the Code (A.3.1) is a test of independence in relation to each particular corporation where office is held. It is not a test of network independence or ties outside that particular boardroom. What occurs is much more accurately described as a negotiation of independence that all parties can live with at this board and every other board, rather than a creation of accountability. Dialogues around control and collaboration are, in fact, an informal sharing of information that may or may not have an effect on delivering distant accountability.

In the US this translates into research on interlocks where discussions about the presence of and effects of what are termed interlocked boards is well-worn ground. The primary concern in the US seems to be the effect of interlocks on firm behaviour rather than on the behaviour of those individuals whose appointments form the basis of the interlock. Following Granovetter,[47] the question for those researching interlocks was whether the embedded nature of economic relations resulted in interlocks powering control or communication.[48] If control over other corporations was the answer in the 1970s, by the 1980s communication through learning from other corporations was the answer presented not least by Useem's[49] influential study of British and American directors. Interlocks helped in the spread of innovation and contemporary business practices. It is unlikely that what was spread was best governance practice – it was far more likely to be conducive to the spread of McBarnet and Whelan's[50] creative compliance to boost short-term profitability. More recent studies in the US have been concerned with corporate donations to political action committees and the role of interlocks. The same questions are asked of interlocks as are asked of the presence of outside directors – what are the effects on takeover defences and compensation payments etc? – thus reflecting two things: the first was referred to above – that structural not behavioural determinants are what matters for agency theory; and the second, that interlocks are caused more often by non-executive or outsider director interchange rather than by executive director exchange.

In the UK, the concept of the interlocks is something mentioned only by sociologists, such as John Scott or Richard Whitley, whose interests are primarily in social network analysis and social stratification[51] and not in governance and accountability. We could speculate on why this is. It is no more difficult to map boardroom elites in the UK than it is in the US – all the information needed is publicly available – it may say something more about perceived hierarchies and stability within British society,[52] but it also might be the influence of the "so what" school – what does the presence of interlocks actually tell us?[53] The answer to that question depends on which story is being told – the story about firm performance (to which Pettigrew's comments are directed) or the story about the prospects for effective boardroom monitoring?

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47 M Granovetter, "Economic action and social structure: the problem of embeddedness" (1985) 91 *American Journal of Sociology* 481–510.

48 M Mizruchi, "What do interlocks do? An analysis, critique and assessment of research on interlocking directorates" (1996) 22 *Annual Review of Sociology* 271–98.

49 M Useem, *The Inner Circle* (New York: OUP 1984).

50 McBarnet and Whelan, *Creative Accounting*, n. 28 above.

51 J Scott, *Who Rules Britain?* (Oxford: Polity 1991); J Scott, "Networks of corporate power: a comparative assessment" (1991) 17 *Annual Rev Soc* 181–203; J Scott, *Corporate Business and Capitalist Classes* (Oxford: OUP 1997).

52 M Bond, "Elite social relations and corporate political donations in Britain" (2007) 55 *Political Studies* 59–85, at 61; D Harris and C Helfat, "The board of directors as social network: a new perspective" (2007) 16 *J of Management Inquiry* 227–38.

53 Pettigrew, "On studying managerial elites", n. 39 above.

Recent research by Froud et al.[54] demonstrates that there is an exchange of executive director personnel into non-executive director personnel on retirement, particularly within the FTSE 250. Their key findings were that 60 per cent of FTSE 100 companies had a non-executive director who was an executive director at another FTSE 100 company, possibly suggesting the beginnings of a post-retirement career, but, perhaps more importantly, that in excess of 40 FTSE 100 companies shared a non-executive director with another listed company. More or less the same pattern of appointments emerged from empirical work commissioned by the Higgs Review;[55] sixteen non-executive directors drawn from the FTSE 350 held fifty-four non-executive directorships between them. The same duplication of non-executive appointments was also found by Bond.[56] According to the more recent *Guardian*/Reward Technology Forum report, eight non-executive directors sit on more than three FTSE 100 boards. One might have thought that increased burdens of monitoring on non-executive directors and recent media messages about potential legal liability (rather than actual liability)[57] would have severely reduced the number of people prepared to undertake this role. Instead, what can be observed is that boardroom members, whether they are executives or non-executives, "seem to know one another, seem quite naturally to work together, and share many organizations in common".[58] The incentive for individual directors to hold non-executive and executive appointments at the same time and for non-executive directors to hold more than one appointment at the same time is partly salary uplift but also the opportunity to observe how others deal with the demands of monitoring, to capture innovation from a range of sources and to gain general network endorsement.[59] The incentive for boards to recruit as non-executive directors existing executive directors or outside directors already serving elsewhere is based upon prior experience – their recruits will know what to expect – skills in the area of shareholder relations, takeover defence strategies, and network endorsement, even if these recruits do not have the skills that some institutional investors think they should have. Knight Vinke has, following its much publicised dispute with HSBC over the suitability of Stephen Green as CEO, recently made public its view that non-executives in the banking sector in particular should have a fund assigned to them on which they can draw to obtain their own advice. This concern with the financial management skills of non-executive directors can be linked to the findings of Froud et al.[60] that the percentage of non-executive directors from the financial sector has declined over the last thirty years, unlike in the US landscape where the trend is reversed.[61]

What we do not know is what the consequences of network membership and reputation have for accountability concerns. The post-Higgs Review desire for more non-executive directors is likely to result in a thickening of network ties – there is a finite pool of recruits with these skills available. The corporate governance system itself drafts for interlocks. One

54 J Froud, A Leaver, G Tampubolon and K Williams, "Everything for sale: how non-executive directors make a difference" in M Savage and K Williams (eds), *Remembering Elites* (Oxford: Blackwell 2008).

55 Roberts et al., "Beyond agency", n. 45 above.

56 M Bond, *The Effects of Inter-corporate Networks on Corporate Social and Political Behaviour* (London: ESRC End of Award Report 2006), www.esrc.ac.uk, award ref 000-22-0872.

57 B Black, B R Cheffins and M Klausner, "Liability risk for outside directors: a cross-border analysis" (2005) 11 *European Financial Management* 153–71.

58 C Mills, *The Power Elite* (New York: OUP 1956), at p. 294.

59 S Westphal and I Stern, "Flattery will get you everywhere (especially if you are a male Caucasian): how integration, board room behaviour and demographic minority status affect additional board appointments at US companies" (2007) 50 *Academy of Management Journal* 267–88.

60 Froud et al., "Everything for sale", n, 54 above.

61 N Fligstein and K Dauber, "Intraorganizational power struggle: the rise of finance presidents" (1987) 52 *American Sociological Review* 44.

of the more interesting features of UK company law, with its mix of common law and statute, was that although common law hinted that interlocks might not be permitted (as in difficult to accomplish without a breach of fiduciary duty), successive Companies Acts ignored the issue and remained silent. The Companies Act 2006, which came into force in October 2008, appears to suggest that directorial conflicts of interest must be declared and can then be ratified by non-conflicted directors. However, at the drafting stage assurances were given that nothing in this new clause (s. 175) was new law; it was merely confirming what the case law had been since 1845 and would not make multiple directorships more difficult. Code drafters and amenders are well aware that there is a limited pool of talent on which to draw within corporate boards and that little attempt is made to find talent in any other pool. Code drafters and amenders are themselves part of the circularity of boardroom appointments. Reputation within the network is maintained not by being an effective monitor but by negotiating sufficient independence to be associated with success and untainted by failure. Higgs was invited to put a limit on the number of boardrooms in which any one individual could sit in any capacity and declined to do so. When questioned by a journalist about his own portfolio of corporate activity (four non-executive directorships and two executive directorships), he answered that "if any of the companies feel that I am not giving the job enough attention they will say so". That comment is an agency theorist's worst nightmare – the group supposed to comment on lack of attention and any consequent monitoring failure is the shareholders. There is a certain circularity to accountability in the boardroom – the watchers (executive directors) are watched by other watchers (non-executive directors) who themselves are watched by shareholders through disclosure to the market. It has the look of a rather unedifying dance.

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A global framework for management commentary disclosure?

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Introduction

Financial statements alone do not sufficiently enable users to have a complete understanding of a particular business. The management commentary, which is a narrative report, therefore "comprises information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions".[1] On this basis the International Accounting Standards Board (IASB) and partner standard-setters suggest that IAS 1 *Presentation of Financial Statements* should eventually include a requirement to prepare a management commentary. The IASB is therefore currently working on a project for developing an international framework for management commentary disclosure, with the intention of completing a guidance document during 2009.[2]

The IASB seeks to create a best-practice approach corresponding with recent developments in various jurisdictions relating to narrative reporting. The UK's experience relating to the introduction of the enhanced business review requirements reveals some of the potential problems that must be overcome not only nationally but internationally also. In turn, the IASB's project is likely to impact upon the business review requirements recently introduced in the UK.[3] The effectiveness of reporting under these new requirements may be measured against the IASB's approach to this issue. The work of the IASB is likely to shape judgments by managers and directors about what material to include in their business reports and it will also influence how the emerging reports are received by their users. The extent to which the current interpretations of the UK legislation match the IASB's thinking is relevant to the question of the prospect for successful harmonisation or convergence internationally of requirements for management commentary.

A leading commentator has suggested recently that convergence of international accounting standards generally reflects attempts to strengthen and spread a particular

1 Preface to *International Financial Reporting Standards*, para. 7.

2 See IASB, *Management Commentary: A paper prepared for the IASB by staff of its partner standard-setters and others* (hereafter Discussion Paper), October 2005. See also the IASB current projects webpage which provides details of the latest developments relating to the management commentary project.

3 Companies Act 2006, s. 417.

version of global capitalism rather than genuinely to improve corporate governance.[4] The management commentary agenda in its current form lends support to this claim.

This paper will explore, in part 1, why efforts are being made to converge accounting regulation internationally and, in part 2, why the IASB considers extending those efforts by introducing guidance for a management commentary. In part 3, the paper will review existing management commentary requirements in other jurisdictions with particular focus on the new provisions introduced by the Companies Act 2006 in the UK. Part 4 will highlight key differences and similarities among the jurisdictional requirements. Part 5 will consider the IASB's principles-based approach to accounting standards and the management commentary. Part 6 will identify the intended users of management commentary and part 7 will consider the emphasis on managerial discretion which is related to the issue of directors' liability considered in part 8. Part 9 will explore the effects of the UK legislation to date and will suggest how implementation of this legislation might be influenced by the IASB's approach. Finally, the paper will conclude with remarks about the prospects for successful international convergence of management commentary regulation and the likely impact of these developments on international corporate governance more generally.

1 International convergence of accounting rules

According to Sir David Tweedie, then (and current) chair of the IASB, and Thomas R Seidenstein, director of operations of the International Accounting Standards Committee (IASC) Foundation, "the growing consensus around the benefits of International Financial Reporting Standards (IFRSs) reflects trends in an increasingly integrating global economy . . . disparate national solutions to accounting's problems are not sufficient for an increasingly globalized market".[5] In their article, Tweedie and Seidenstein observe the emergence of global capital markets in which it is possible for companies to list on major international exchanges outside their home jurisdictions giving them greater access to cheaper capital, and in which investors have gained new opportunities for diversification.[6] The development of this globalised capital market gives rise to a need for international accounting standards with a consistently applied common financial language that will make comparable the financial results of companies operating in different jurisdictions.[7] In this context, the reasons for standardisation appear to be reasonably straightforward. To continue with different accounting methodologies and reporting systems as markets are integrating would merely reduce comparability and might also mislead markets and capital allocation.[8] Padoa-Scioppa suggests that such differences encourage a competition in laxity with countries lowering their standards "in a short-sighted attempt to attract listings or to appeal to special interests".[9] The alternative of one set of standards should reduce compliance costs for multinational companies by avoiding the need to prepare different sets of accounts to satisfy different national requirements.[10] One consistent international

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4 L A Cunningham, "The SEC's global accounting vision: a realistic appraisal of a quixotic quest", George Washington University Law School Public Law and Legal Theory Working Paper No. 401, 2008 (forthcoming in the *North Carolina Law Review*).

5 D Tweedie and T R Seidenstein., "Setting a global standard: the case for accounting convergence" (2005) 25 *Northwestern Journal of International Law and Business* 589, at 589–90.

6 Ibid., p. 590.

7 Ibid., p. 591.

8 T Padoa-Scioppa, "Comment", *Financial Times*, 19 May 2006, quoted in IASB, "Work on converging accounting standards must go on", 22 May 2006, at www.iasb.org/news/announcements+and+speeches (last accessed 8 July 2008).

9 Padoa-Scioppa, "Comment", n. 8 above.

10 Tweedie and Seidenstein, "Setting a global standard", n. 5 above, p. 591.

approach to accounting would also remove barriers to capital flows and would encourage more consistent accounting and auditing practices internationally which would also ease the tasks of regulators by reducing the need for them to understand different reporting requirements.[11] The existence of a set of international standards that already had credibility in international capital markets would also benefit those jurisdictions without fully developed national standards by providing them with a ready made set of standards to meet the needs of their larger domestic companies.[12]

Since the IASC was founded in 1973 there has been significant progress in the work towards the development of a set of international accounting standards. Having started as a part-time standards-setter, the IASC was restructured and reconstituted in 2001, becoming the International Accounting Standards Board, a better-resourced, full-time professional standards-setter.[13] The IASB states that its main objective is to construct a set of accounting standards based on the best standards around the world that constitute the highest denominator of financial reporting.[14] In this way, convergence is based on the aims of improving financial reporting and of achieving consistency across capital markets. The IASC completed a core set of standards in 1998 which later received a qualified endorsement from the International Organization of Securities Regulators in 2000.

Since the IASB was inaugurated there has been significant success in establishing the IFRSs as the international basis of accounting. These standards are now fully accepted for overseas registrants by most of the world's stock exchanges and many countries have adopted the standards for unlisted companies and also as a model for their domestic standards. The European Union adopted a regulation in 2002 that requires publicly traded companies since 2005 to apply IFRSs for their consolidated accounts.[15] Indeed, according to Jeff Willemain, of Deloitte, "the European Union's successful adoption of IFRS in 2005 spurred a sea-change in attitudes toward common standards of reporting. Today, more than 100 countries report under the international standards."[16] These include Australia, South Africa, China, Hong Kong and many Latin American countries, which also converged with or adopted IFRS as their national standards.[17]

In earlier times a major incentive for convergence rested with European companies seeking access to the strong US capital markets.[18] The cost of their obligation to comply not only with their own national and European accounting regimes but also to reconcile their accounts with US GAAP (Generally Accepted Accounting Principles) requirements

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11 Tweedie and Seidenstein, "Setting a global standard", n. 5 above, p. 591.

12 G Whittington, "The adoption of international accounting standards in the European Union" (2005) 14 *European Accounting Review* 127, at 129.

13 See D S Ruder, C T Canfield and H T Hollister, "Creation of world wide accounting standards: convergence and independence" (2005) 25 *Northwestern Journal of International Law and Business* 513. See also M J Hanson, "Becoming one: the SEC should join the world in adopting International Financial Reporting Standards" (2006) 28 *Loyola LA International and Comparative Law Review* 521, at 524–7.

14 Tweedie and Seidenstein, n. 5 above, p. 592, citing the objectives laid down in the IASC Foundation Constitution 5 of 2002.

15 Council Regulation 1606/2002 of 19 July 2002 on the Application of International Standards, 2002 OJ L 243, 1, 1–4.

16 J Willemain, "Corporate reporting: trends and tensions in convergence" (2008) *International Corporate Governance Network Yearbook*, available on Deloitte website: http://www.deloitte.com (last accessed 5 August 2008). Jeff Willemain is global managing partner in the regulatory and risk section of Deloitte.

17 See IASPlus, Deloitte & Touche, "News about international financial reporting", at www.iasplus.com cited by Tweedie and Seidenstein, "Setting a global standard", n. 5 above, p. 592.

18 S B Eaton, "Crisis and the consolidation of international accounting standards: Enron, the IASB, and America" (2005) 7 *Business and Politics* (article 4), available at http://bepress.com/bap (last accessed 8 July 2008), p. 4.

would prohibit their entry into the American markets. A solution to this problem would be the development of a set of international standards applicable in all jurisdictions. For much of the time the US has shown greater reluctance to converge, with the Securities and Exchange Commission (SEC) making "effective use of the lure of US capital markets" and the Financial Accounting Standards Board (FASB) playing on the "commonly held view that American rules were best of breed" and advocating the adoption of US GAAP as the world's accounting standards as an alternative to international harmonisation.[19] More recently the dramatic accounting scandals that have shocked America have instigated a change of attitude.

The Enron fiasco resulted in the US accounting authorities warming to principles-based standards[20] and showing a greater willingness to work towards creation of international standards.[21] The IASB and the FASB signed the Norwalk Agreement in October 2002 in which they agreed on a short-term project to eliminate minor differences between the international and the US standards, to address emerging issues jointly and to promote consistency in the pronouncements of both their interpretative committees. This agreement was updated in 2008 to include efforts towards convergence between US GAAP and IFRS. In November 2007, the SEC also demonstrated greater acceptance of the international standards by voting to scrap the reconciliation rule for foreign companies using IFRS to prepare their financial statements.[22] Also, in 2008, the chair of the SEC, Christopher Cox, announced in a speech a proposed roadmap to include a schedule and appropriate milestones towards acceptance of IFRS.[23]

It might be considered from the above account that the US accounting regulators have compromised and shown a willingness to alter their position on accounting practice and regulation. However, it should also be remembered that since the origins of the IASC the US has played an influential role in its activities and those of its successor, not least because of funding and membership from US professional bodies and indirectly from the influence of the SEC on the International Organization of Securities Commissions (IOSCO) which, itself, has largely driven much of the IASC/IASB's activities. Thus some commentators have suggested that the IASB's work has been consistent with an "alignment internationally to an Anglo-American (becoming American) accounting, nested in related political economy".[24] Nevertheless, some difficulties remain. First, in the US, the rules-based approach has favoured a belief in subjecting all to the same standards, and this is reinforced

19 Eaton, "Crisis", n. 18 above, p. 6. Some would argue that critics exploited the Enron debacle to complain that US GAAP was too detailed and had too many rules whilst the more general character and language of the IFRS were more appealing in competitive capital markets: see e.g. Cunningham, "SEC's global accounting vision", n. 4 above, p. 12.

20 See e.g. SEC, *Study Report Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002* (Washington: SEC 2003), recommending that "those involved in the standard setting process more consistently develop standards on a principles-based or objectives-oriented basis"; p. 5.

21 Eaton, "Crisis", note 18 above, p. 13.

22 See SEC, "Acceptance from foreign private issuers of financial statements prepared in accordance with IFRS without reconciliation to US GAAP", Release No. 33-8879, 21 December 2007, at www.sec.gov/rules/final/2007/33-8879.pdf (last accessed 8 July 2008).

23 See C Cox, "Remarks before US Chamber of Commerce", speech by SEC chair Christopher Cox, 18 April 2008, at www.sec.gov/news/speech/2008/spch041808cc.htm (last accessed 8 July 2008).

24 S Gallhofer and J Haslam, "Exploring social, political and economic dimensions of accounting in the global context: the International Accounting Standards Board and accounting disaggregation" (2007) 5 *Socio-Economic Review* 633–64, at 641.

by Sarbanes-Oxley compliance.[25] This contrasts with the principles-based approach. Secondly, there remains some irritation in the US about the EU's variation of the IAS 39, relating to hedge funds.[26] Thirdly, there continues to exist considerable opposition from US chief finance officers to allowing companies to switch to IFRS or to allowing foreign companies to report against IFRS without reconciliation to GAAP.[27] However, the reality of competition for global capital investments has pushed the SEC to nurture an enthusiasm for IFRS, noting that otherwise companies are likely to delist from the New York Stock Exchange and NASDAQ.[28] Ultimately, as stated by Willemain, "taken together, the writing on the wall is clear: the debate over *whether* to move toward convergence of accounting standards has given way to a discussion of *how* to move to global standards".[29]

This significant progress in achieving wide-scale acceptance of the IFRS has encouraged the IASB to deepen its work and broaden the scope of its projects. One such move was to introduce a project on the possible development of an international standard or guidance for management commentary. The next section of this paper will consider the role of management commentary in financial reporting before going on to provide an overview of existing national requirements and practices.

2 The IASB's vision of management commentary

The IASB recognises that financial reporting is not sufficient to provide users with a full understanding of the company's business and position. Management commentary, in theory, plugs the gap by providing information that supplements and explains the financial reports. The aim is to provide a fair and balanced account of the business and to act as a corporate governance tool by which the users of the report may assess the performance of the company's managers in the fulfilment of their duties. In its Discussion Paper, the IASB defines management commentary as

> information that accompanies financial statements as part of an entity's financial reporting. It explains the main trends and factors underlying the development, performance and position of the entity's business during the period covered by the financial statements. It also explains the main trends and factors that are likely to affect the entity's future development, performance and position.[30]

The Preface to *International Financial Reporting Standards* states that "other financial reporting" – such as management commentary – "comprises information provided outside financial

25 A Shipman, "Transatlantic strain still threatens global accounting standards", 29 October 2007, available at www.accountingweb.co.uk/cgi-bin/item.cgi?id=174918&d=1032&h=1024&f=1026&dateformat=%25o%20%25B%20%25Y (last accessed 11 September 2008).

26 Ibid.

27 Ibid. See also S Thetford, "Global accounting harmonization: a challenging change" (2005) *The Trusted Professional*, at www.nysscpa.org/printversions/tp/405/article5.htm (last accessed 11 September 2008), noting that Sarbanes–Oxley has contributed significantly to the decrease in listings on the US markets due to the added costs of compliance. The result has been more listings in Europe and a greater use of IFRS.

28 Shipman, "Transatlantic strain", n. 25 above.

29 Willemain, "Corporate reporting", n. 16 above.

30 Discussion Paper, n. 2 above, para. 35. See also the definition provided by the Technical Committee of IOSCO: "The purpose of the MD&A is to provide management's explanation of factors that have affected the company's financial condition and results of operations for the historical periods covered by the financial statements, and management's assessment of factors and trends which are anticipated to have a material effect on the company's financial condition and results of operations in the future. Companies should provide the information that is necessary for an investor's understanding of the company's financial condition, changes in financial condition and results of operations."

statements to assist in the interpretation of a complete set of financial statements or improve users' ability to make efficient economic decisions".[31]

The IASB identifies in its Discussion Paper a number of roles for management commentary. Management commentary comprises a narrative explanation of the company's business position that improves disclosure and transparency by supplementing the information given in the financial statements. The IASB expresses a preference for a management commentary that not only explains the performance, position and future prospects of the business but that also provides a fair review of the development of the business and its position by showing how the company has grown or changed in the current year and how it expects to grow or change in the future. The management commentary "supplements and complements financial information, providing insights into an entity's performance that financial statements cannot, and should not, be expected to achieve on their own". Management commentary also enables the company's management to review the actual performance of the business and the position it has achieved and to explain different outcomes from previous expectations. Investors may be informed about circumstances that may have affected the outcomes and to what extent strategies adopted by management achieved their objectives. Thus, through the management commentary the company's management is able to explain and provide a rationale for its current and future strategies and prospects. Management commentary is not to be seen as separate from the financial statements and nor should it be placed within them, but rather by accompanying and explaining the financial statements it should sit alongside them.

The IASB proposed in its Discussion Paper the introduction of a mandatory standard for a management commentary. This proposed standard would have taken into account the similarities and the differences of approach among the various jurisdictions considered. The objective of the management commentary set out in the proposed standard was to provide information to help investors: to interpret and assess the related financial statements in the context of the environment in which the entity operates; to assess what management views as the most important issues facing the entity and how it intends to manage those issues; and to assess the strategies adopted by the entity and the likelihood that those strategies will be successful.

The IASB makes clear that the management commentary should supplement and complement information in the financial statements and that it should provide an analysis through the eyes of management. It should have an orientation to the future and it should be understandable, relevant, supportable, balanced and comparable over time. The proposed standard would also have given guidance as to: the intended content of a management environment in which it operates; the business objectives and strategies in place to achieve them; key resources, risks and relationships that management believes may affect the entity's long-term value and how those key resources, risks and relationships are managed; financial and non-financial results and the extent to which the performance indicates future results and management's assessment of future prospects; and a description of performance measures and indicators used against the stated objectives. Within each of these areas listed the proposed standard would have given further detail about what should be included to meet the required coverage. The proposed standard was not to prescribe the form of the commentary, stating instead that this depends on the different businesses. Following responses to the Discussion Paper, the IASB has opted to develop a guidance document instead of a mandatory standard. The potential adoption problems among various jurisdictions persuaded the IASB that a non-compulsory guidance

31 Preface, n. 1 above, para. 7.

document would be a more appropriate way forward with potential, in the longer term, to move on to creating a standard.

3 Existing management commentary requirements in different jurisdictions

The IASB's project is inspired by the fact that many jurisdictions recognise management commentary as an essential reporting document. In its Discussion Paper the IASB describes the rules in a number of jurisdictions including the UK. In the United States the Management Discussion and Analysis (MD&A) is regarded as a regulatory matter by which the SEC has required listed companies to provide an MD&A since 1968. The SEC considers that a numerical representation and brief accompanying footnotes alone may be insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance and so an MD&A allows managers to provide additional information necessary to understand a firm's financial condition, changes in financial condition and, results of operations. The SEC states that the MD&A is "intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company". A similar definition is provided in Canada. The Canadian Securities Administrators issued new MD&A requirements in National Instrument 51–102 Continuous Disclosure Obligations and described the MD&A as "a narrative explanation, through the eyes of management, of how your company performed during the period covered by the financial statements, and of your company's financial condition and future prospects".

In Australia, the Corporate Law Economic Reform Program Act (CLERP) 2004 amended s. 299A of the Corporations Act to require expanded directors' reports. Thus, listed companies must provide information for members who would reasonably require to make an informed assessment of the operations of the entity, its financial position and its business strategies and prospects for future financial years. CLERP and the Australian Stock Exchange also make reference, for the purpose of legislative compliance, to the Group 100's Guide to the Review of Operations and Financial Condition. The guide states:

> The Review should provide users with an understanding of the company by providing a short-term and long-term analysis of the business as seen through the eyes of the directors. This will be facilitated by providing useful financial and non-financial information and analysis . . . A contemporary Review should include an analysis of industry-wide and company-specific and non-financial information that is relevant to an assessment of the company's performance and prospects.

New Zealand has no specific requirement for a management commentary but its financial reports generally have a wider scope and FRS-9 Information to be Disclosed in Financial Statements requires in a prospective report a comparison with actual performance.

The European Union has also legislated for the provision of management commentary. The Accounts Modernisation Directive amended the Fourth and Seventh Directives to require the annual report to

> give an indication of any important events after the balance sheet date, the likely future development of the entity, the activities in the field of research and development, and the risks relating to the use of financial instruments including their management.[32]

32 Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings, OJ L 178, 17/07/2003, pp. 16–22, Art. 46 Fourth Directive, and Art. 36 Seventh Directive.

The Modernisation Directive requires the annual report to include "at least a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces". The directive clarifies the requirement as

> to the extent necessary for the understanding of the company's development, performance or position, the analysis shall include both financial and where appropriate, non-financial key performance indicators relevant to environmental and employee matters . . . the annual report shall, where appropriate, include references to and additional explanations of the amounts reported in the annual accounts.

Germany has required a form of management commentary since 1931 and the requirements have been modified and developed over time. In 2004, a new GAS (German Accounting Standard) 15 Management Reporting was adopted, based on the EU legal requirements and taking into account requirements and practice in the US, Canada and the UK. Thus, in order to reduce the gap in information available to investors and managers, the group management report must present a fair review of the development of the business and of the group's position.

> Expected developments shall be assessed and discussed together with the significant risks and opportunities . . . Management reporting is intended as a vehicle for presenting information to users from management's perspective . . . The focus should be on sustainable value creation . . . The main factors which could influence changes in the value of the enterprise in the future should be disclosed and discussed . . . It is recommended that the key performance indicators used internally to manage the group are quantified.

A more recent information document published by the IASB describes the jurisdictional requirements of thirteen additional countries[33] and these range from having no regulation for narrative reporting[34] to regulation of limited or moderate detail focused primarily on corporate governance[35] or on accounting matters[36] and, finally, to countries with detailed narrative reporting regulations.[37]

This part will be completed with a more detailed description of the UK requirements as not only has the UK's approach prior to the finalised regulatory requirements influenced the views of the IASB, but also in order to consider, as I set out to do in this paper, how the UK's requirements are likely to be affected by the IASB's project.

The UK's business review requirements introduced in the Companies Act 2006

Prior to the introduction of the Companies Act 2006, there was in place a voluntary system for companies to produce an Operating and Financial Review (OFR) for which companies were guided by a Reporting Statement of best practice principles published by the Accounting Standards Board (ASB). All quoted and unquoted companies except for small companies were also required to include an enhanced business review under s. 234ZZB of the Companies Act 1985 and Sch. 7 of the same Act. During the discussions leading to the

33 IASB, "Information for observers, additional research re management commentary", related to Board Meeting of 24 July 2008, at www.iasb.org.

34 Albania, Nigeria and Uruguay, though Nigeria requires banks to report a strategy review to the central bank and in Uruguay publicly traded companies must inform the government of their economic and financial situation.

35 Philippines, Taiwan and Peru.

36 Pakistan, Brazil, Singapore and Hong Kong.

37 Turkey, Israel and Russia.

reform of company law and the new Companies Act 2006 a major part of the reform agenda was the introduction of new requirements for a mandatory operating and financial review through which the Reporting Statement was to be turned into a Reporting Standard with detailed mandatory information requirements. It is those provisions and, in particular, the ASB's Reporting Statement, that have shaped the IASB's proposed standard. However, to the dismay of many stakeholders in the UK, Gordon Brown, who was then Chancellor of the Exchequer, announced in November 2005 that the rules for the OFR would be abolished.[38] Following further consultations, new requirements were introduced that now form part of the Companies Act 2006.

The resulting provisions in the Companies Act 2006[39] seek to streamline provisions for narrative reporting so that the requirements for quoted companies are more closely aligned to those for unquoted companies. Section 417 provides that unless the company is subject to the small companies' regime, the directors' report must contain a business review.[40] The purpose of the business review is stated in s. 417 of the Companies Act 2006 to be "to inform shareholders of the company and help them assess how the directors have performed their duty under s. 172 (duty to promote the success of the company)".[41]

Section 417, subs. (3), (4), (6) and (8) specify the contents required by all companies required to produce a business review. Subsection (5) provides further prescription for quoted companies and this subsection highlights more obviously the connection with the s. 172 duty.[42]

In s. 417, subs. (3) and (4) restate the earlier provision in s. 234ZZB:

> (3) The business review must contain—
>
> (a) a fair review of the company's business, and
>
> (b) a description of the principal risks and uncertainties facing the company.
>
> (4) The review required is a balanced and comprehensive analysis of—
>
> (a) the development and performance of the company's business during the financial year, and
>
> (b) the position of the company's business at the end of that year, consistent with the size and complexity of the business.

Subsections (6) and (8) also restate the earlier provisions relating to the content of the business review. Thus, subs. (6) specifies that the review

> must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—
>
> (a) analysis using financial key performance indicators, and
>
> (b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

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38 For a description of the previous requirements and the discussions leading to reform of company law in the UK, see C Villiers, *Corporate Reporting and Company Law* (Cambridge: Cambridge UP 2006).

39 Note the insertion of new clauses in the Companies Bill, following extensive consultations: Department of Trade and Industry, "New clauses to keep company law reform 'light touch'", 3 May 2006, at www.dti.gov.uk.

40 S. 417(1).

41 S. 417(2).

42 See below.

According to the subsection, the term "key performance indicators" (KPIs) means factors by reference to which the development, performance or position of the company's business can be measured effectively.

Subsection (8) provides that the review must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.

These provisions underline the importance of financial information – insofar as financial KPIs are compulsory and the business review is required, where appropriate, to link itself to and provide further explanation of the annual accounts. The other KPIs, including environmental and employee matters need only be included "where appropriate".

4 Identifying common and distinct features across the jurisdictions

The above brief overview of requirements among different jurisdictions shows that they have in common a clear aim for the management commentary. It is a document meant to enable users to understand the company's performance in a way that would not be possible if they were only supplied with the financial statements. The management commentary supplements and explains the information provided in the financial statements. Across all the jurisdictions described, the management commentary is also a tool that provides management with an opportunity to review and explain the company's performance and position and to consider and lay out to the users of the report the company's future prospects. In all the jurisdictions profiled here there are certain points of information that the commentary must contain. These are the main trends and factors affecting the company's current and future financial condition and performance. All jurisdictions surveyed highlight that the document should include a description of the company's business and the market in which it operates, the development and performance of the business and its financial performance and results, resources available to the business, and its assets, risks, performance measures and indicators and future prospects.

These similarities among the different jurisdictions suggest a possibility of convergence or a harmonisation of requirements. On the other hand, there are a number of features exhibiting important differences among the capital markets. For example, as has been noted above, the US favours a rules-based system whilst the UK is more principles-based in its approach. Some jurisdictions highlight the need for information about relationships with the company whilst others do not mention such relationships. Whilst many of the jurisdictions surveyed view the management commentary as a report that sets out an analysis of the business through the eyes of management, not all incorporate that requirement.[43] Nor do all jurisdictions require future-oriented information.[44] The IASB also identifies a further conceptual tension between management commentary and IFRSs because many jurisdictions include in their narrative reporting requirements information that is required within individual financial reporting standards and this is likely to lead to further discussion about placement of disclosures.[45]

The work of the IASB has significance for the future character of management commentaries and is likely to influence interpretation of the recently introduced requirements in the UK. A number of matters are particularly relevant, such as to what extent the management commentary requirements should be rules-based or principles-based. The IASB's view is that non-financial disclosures are still in their infancy, particularly in relation to form and content, and they are still evolving internationally. On this basis the

43 IASB, "Information for observers", n. 33 above, para. 24.

44 Ibid.

45 Ibid., paras 25 and 26.

IASB considers it premature and counterproductive to introduce detailed regulation at this stage. The IASB's current plan is to develop a guidance document that will outline best practice in formation and presentation of a management commentary. There are certain aspects that might be expected to be included within a management commentary but the form of their presentation and how detailed they should be remain open questions.

5 Rules or principles?

The IFRSs developed by the IASB have generally consisted of a principles-based approach rather than a rules-based approach. Various theoretical claims surround the preference by numerous regulators for a principles-based approach as opposed to a rules-based regime. Julia Black, moreover, points out the rhetoric of principles-based regulation: it provides a regulatory Utopia in which "regulation is targeted and focused, and preferably harmonized across jurisdictions, regulated firms are given the flexibility they need to get on with running their businesses, and consequently regulatory outcomes are achieved with no undue cost to business".[46] This Utopia is supported by many claims, for example, that they have been adopted and applied more flexibly across companies and countries.[47] The principles-based approach also minimises, in theory, potential for conflict with existing laws and accounting practices and rules-based national standards have been able to coexist alongside the IFRS with the avoidance of political arguments about their effect on the national system.[48] The principles-based approach has also encouraged the introduction of a guidance document for management commentary because it can more easily be relied upon to extend accounting principles beyond purely financial matters and into the general statements accompanying company reports without opposition from national standard-setters.[49] According to Donnelly, this fact

> means that the IASB's activity is likely to support the OECD's [Organization for Economic Co-operation and Development] strategy to promote transparency and qualitative information about corporate governance as part of financial reporting without raising concerns about firm demands on reporting standards that could become easily politicised.[50]

The principles-based approach then, appears to have provided a starting point from which a discussion on management commentary could be pursued. In the same vein, the IASB adopted the view in its Discussion Paper that a principles-based approach would be more appropriate than specifying the precise information to be disclosed within the management commentary or how it should be presented. Thus the favoured approach would be for the requirements to set out the principles, qualitative characteristics and essential areas necessary to make the information in the management commentary useful to investors.

The IASB identifies the main principle as the provision of information that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions. In addition, the management commentary provides information that supplements the financial statements and explains the amounts reported in

46 J Black, *Forms and Paradoxes of Principles Based Regulation*, LSE Law, Society and Economy Working Paper 13/2008, at http://ssrn.com/abstract=1267722.

47 S Donnelly, "The International Accounting Standards Board" (2007) 12 *New Political Economy* 117, at 121.

48 Ibid.

49 Ibid., pp. 121–2.

50 Ibid., p. 122. See also R D Kershaw, "Evading Enron: taking principles too seriously in accounting regulation' (2005) 68 *Modern Law Review* 594, suggesting that the UK accounting regulators portrayed their approach as principles-based and thereby saved themselves from the political fallout which hit accounting regulation in the US in the wake of Enron's collapse, even though the accounting provisions in the UK and the US were almost identical: noted by Black, *Forms and Paradoxes*, n. 46 above, p. 11.

the financial statements and the conditions and events that shaped that information in the financial statements. The information that complements, and therefore is not included in, the financial reports should include financial and non-financial information about the business and its performance. Another guiding principle is that the information that management deems important is also important to the users and, thus, the management commentary should provide an explanation of the company's financial statements that enables users to see the company through the eyes of management. The management commentary should also have an orientation to the future and thereby should help users to assess future prospects. The orientation to the future, according to the IASB, is about communicating through management's eyes, the direction the entity is taking, by, for example, setting out future strategies and goals. This principle does not require the management commentary to contain forecasts or predictions. In summary, the management commentary should be useful to its users and enable them to understand the financial statements through management's eyes and be able to assess the company's future prospects.

The downside of this principles-based approach, of course, is that it does not necessarily subject all companies to the same standard but, instead, is a flexible approach aiming to achieve compliance with the spirit, rather than the letter, of the law. This has its merits but, from the point of view of international standardisation, is unlikely to achieve that end. Moreover, some commentators identify a number of weaknesses in the principles-based approach. Bratton, for example, suggests that whilst there is a lack of confidence in management incentives respecting accounting treatments and doubts about the level of auditor independence, "we have no actor plausibly positioned to make the delicate law-to-fact determinations called for in a principles-base system". On this basis, Bratton argues that "accounting rules, with all their flaws, will continue to be the best choice in a second-best world so long as they constrain managers and auditors most of the time".[51] Bratton predicts that the adoption of a principles-based approach would lead to a decrease in the level of reporting detail and an enhancement of comparability of treatment across different issuers. At the same time, there might occur a loss of transparency because the particulars in the economics of differing underlying transactions would be obscured. Furthermore, in order to operate effectively, a principles-based system requires professional auditors and lawyers who are empowered vis-à-vis their clients. In the US, that has not always been the case and so such professionals rely on the existence of rules in order to be able to say no to their clients. Currently, in the US, the regulated actors make the law-to-fact decisions, rather than judges empowered by the state. Those regulated actors rely on input from their auditors, who, unlike judges can only suggest no rather than say no absolutely. The auditors have little incentive to suggest no and thereby forego the rent they receive from an audit engagement. Bratton also notes that in other areas of commercial and business law there has been a shift towards more precise rules and away from broad standards. As he observes, "business law and lawyers no longer subscribe to the legal realists' view that fact-specific adjudication under standards makes law more responsive".[52] Furthermore, the movement towards rules has occurred partly because of a decline in confidence in judicial decision-making, partly because rules are perceived to offer more certainty than standards, and they appear to reduce risk for lawyers and their clients since a rule "imports a safe harbor and control of future events where a standard does not". Finally, Bratton suggests that a move towards a principles-based approach is not likely to increase transparency. On the contrary,

51 W W Bratton, "Enron, Sarbanes-Oxley and accounting: rules versus principles versus rents" (2003) 48 *Villanova Law Review* 1023, at 1037.

52 Ibid., p. 1050.

since decision-making about treatments goes on in a black box, such decision-making evolves as a matter of practice amongst the insiders.

In the move towards international convergence, Bratton suggests that a principles-based approach is better suited to blockholding systems which are characterised by closer corporate governance monitoring from control shareholders in contrast with dispersed shareholder arrangements.[53] Blockholders may intervene earlier and more cheaply in cases of management failure and they have greater ability to access information about operations. Additionally, blockholder systems usually involve longer shareholder time horizons which free management to invest for the long term and there will be less external pressures threatening insiders' control. This reduces incentives to manipulate numbers and thereby also frees the auditor to exercise judgment bound up in the application of a standard. Furthermore, according to Bratton, since the blockholder has direct access to corporate information, the numbers in the audited financial accounts are less significant. Auditors also have more reputational interests to lose in blockholding systems where they work for a closed club of top managers, large financial institutions and wealthy individuals who together can impose reputational sanctions more quickly than can dispersed shareholders. These observations indicate that the debate is not over on the essential cultural difference between the US and European accounting systems. Whilst the US appears to be letting go slowly of its rules-based approach, these difficulties identified by Bratton will have to be addressed. The Financial Services Authority (FSA) in the UK offers an interesting case study of the problems identified with a principles-based system. In particular, the principles-based approach requires effective discourse practices. As Black suggests, "regulatory conversations as to the meaning and application of the rules takes centre stage as their meaning and application is elaborated on in iterated communications between regulator and regulated". Whilst this approach, "both relies on and reinforces the image of the self-observing, responsible organization"[54] it also entails the maintenance of a costly communications network that may further trigger conditions of regulatory capture.[55] The purposive objectives and outcome-oriented approach of the principles-based regulation relies on conversational elements but these require difficult, expensive networks and may involve varying interpretive communities. Some have suggested that the FSA takes a more pro-industry approach, willing to tolerate behaviour harmful to investors rather than scare off business through increased regulatory costs.[56] Often, in reality, high-level principles are supplemented by a complex group of rules, guidance and other directives. Additionally, as Georgosouli observes, "the emphasis on high-level principles sometimes tends to tip the balance too much in favour of flexibility and at the expense of certainty and predictability".[57] Indeed, one might argue that these are contradictory objectives.

Whilst the debate about rules or principles appears likely to continue, the outlook as far as the management commentary is concerned is that it will at least start off with a principles-based approach. The main principle identified in the IASB's Discussion Paper is for the management commentary to enable users to interpret the financial accounts more effectively or to make efficient economic decisions. This provides a hint as to who are the intended users.

53 Bratton, "Enron", n. 51 above, p. 1054.

54 Black, *Forms and Paradoxes*, n. 46 above, p. 9.

55 A Georgosouli, "The nature of the FSA policy of rule use: a critical overview" (2008) 28 *Legal Studies* 119–39, at 138.

56 J Robert Brown, "SEC v FSA: rules v principles" (2007) *The Race to the Bottom: International governance*, 23 July 2007, available at http://www.theracetothebottom.org/international-governance/sec-v-f (last accessed, 15 September 2008).

57 Georgosouli, "Nature of the FSA policy", n. 55 above, p. 138.

6 Who are the users?

The UK's legal position and the view of the IASB is that the primary intended users are the shareholders. The IASB justifies this position by arguing that it provides consistency with the requirements relating to general financial reporting; that investors in public companies should be the primary focus.[58] Although the range of information accompanying financial statements may be wide and might suggest that management views the scope of the management commentary and its intended audience also to be wide,[59] the IASB maintains that those non-investor stakeholders should receive separate reports relevant to their specific interests and the management commentary should not be a replacement for those other reports such as sustainability and corporate social responsibility reports.[60] Another problem identified by the IASB relating to non-shareholder recipients is that their needs or interests are less well defined or focused,[61] which leads to potential problems for a management commentary, such as how long or how detailed it should be, and then there might also be a problem of lack of comparability.

Respondents to the Discussion Paper also follow this view. The ASB, moreover, expresses agreement with the principle that the focus should be on the needs of the same primary users, as defined in the current IASB Framework, who are the investors, but highlights a potential liability problem if the focus goes beyond current shareholders to include investors more generically, as was seen in the debates in the UK surrounding the OFR.[62] In its response to the Discussion Paper, the ASB does not refer at all to other stakeholders. The Institute of Chartered Accountants in England and Wales (ICAEW) recognises that high quality management commentary will be of interest to a variety of users of financial statements. However, like the ASB, the ICAEW argues that the focus of management commentary should not extend beyond investors. In agreement with the IASB, the ICAEW argues that the more specific information needs of other stakeholders should be met through separate reporting processes, including corporate responsibility and sustainability reports.[63] The ICAEW acknowledges that such issues may also be relevant to investors seeking to assess the financial performance and prospects of the reporting entity.[64] It further notes that if the potential legal duty of care for directors extends beyond members as a body to all investors, including prospective investors, that would lead to "anodyne disclosures and a rigid approach by boards to management commentary".[65]

With regard to the issue of relevant users, those in the stakeholders' camp will be disappointed by the apparent outcome of the UK business review legislation as well as the general consensus response to the IASB's Discussion Paper. When various stakeholder groups were involved in the debates about the business review legislation, the possibility of a broader user pool was apparent. Indeed, in a response to the White Paper *Modernizing Company Law*, the Government stated that the OFR would

58 Discussion Paper, n. 2 above, para. 25.

59 Ibid., para. 26.

60 Ibid., para. 30.

61 Ibid., para. 29.

62 ASB, "Letter to Alan Teixera, of IASB, commenting on the discussion paper", 9 February 2006, at www.iasb.org, Appendix, response to question 4 of the discussion paper.

63 ICAEW, "Management commentary – memorandum of comment submitted in April 2006 in response to the IASB discussion paper 'Management commentary', published in October 2005", at http://www.icaew.co.uk, para. 16.

64 Ibid.

65 Ibid., para. 17.

> be of benefit not only to shareholders and potential investors in companies, but also to all those concerned with wider aspects of company behaviour, whether as employees, local residents, or as interest groups involved in environmental/social issues or general corporate governance.[66]

However, s. 417 of the Companies Act 2006 states that the purpose of the business review is "to inform *shareholders* of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company)".[67] In this way shareholders collectively may exercise their governance rights more effectively. Lord Sainsbury stressed in the House of Lords that the business review "is not designed to help individuals decide on investment decisions, nor is it targeted at the wider public in the sense that they should be entitled to rely on it, although they may well read it".[68] The UK's position is to limit the obligations relating to the business review to the shareholders collectively. Others will not be denied access to the document, but their right to rely on the information reported will not be legally supported.

Shareholders, as capital providers, clearly enjoy a privileged status over other stakeholders as recipients of financial statements and other related reports. In their jointly issued *Exposure Draft* for improving the *Conceptual Framework for Financial Reportin*g, the FASB and the IASB state that present and potential capital providers have the most critical and immediate need for the information in financial reports. Whilst the two boards recognise that other potential users of financial reports also have an interest in making similar assessments to those of the capital providers, they conclude that

> because present and potential capital providers have the most direct and immediate interest in an entity's ability to generate cash inflows and management's ability to protect and enhance capital providers' investments, the Boards decided to designate them as the primary users of financial reporting information.[69]

It might be possible to respond to the potential disappointment of stakeholders by using two of the points made in the joint *Exposure Draft*. First, that without a defined group of primary users, the management commentary would risk becoming unduly abstract or vague. Thus, an identified group of primary users would give the management commentary an important focus.[70] Secondly, as is stated in the existing Framework, "As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy."[71] The same argument could be made for the management commentary. Indeed, it could be argued that the views and interests of shareholders, current and potential, may be undergoing change as a result of increased awareness of the relevance of issues such as sustainability and corporate social responsibility. Shareholders are increasingly likely to desire such information as much as other stakeholders. Indeed, an investment analyst is reported to have stated recently: "We might not be particularly interested in every specific issue mentioned in a CSR [corporate social responsibility] report. But the presence of good CSR reporting tells us there is good CSR management. And that tells us the company as a

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66 Sixth Report of Session 2002–03, HC 439, para. 69.

67 S. 417(2), emphasis added.

68 Lords Hansard, 10 May 2006, col. 920.

69 FASB and IASB, *Exposure Draft, Conceptual Framework for Financial Reporting: The objective of financial reporting and the qualitative characteristics and constraints of decision – useful financial reporting information*, No. 1570-100, 29 May 2008, at para. BC1.19.

70 Ibid., para. BC1.18.

71 IASB, *Framework For Financial Reporting*, para. 10.

whole is well-managed."[72] In response to that statement the group Tomorrow's Company remarked: "Viewed in this light, the quality of the annual report becomes a proxy for the quality of the management team."[73] One company was also reported as stating that "This year was different in that we have moved away from a distinct CSR report or section because it has become so embedded in what we do."[74]

The relevance of environmental, social and governance issues for investment decisions is increasingly recognised because of the "body of creditable evidence demonstrating that such considerations often have a role to play in the proper analysis of investment value".[75] Not only is there a growing popularity in "socially responsible investing" but integrating environmental, social and governance considerations into an investment analysis is likely to obtain more reliable predictions of financial performance.[76] Shareholder value today is not limited to short-term profit. In the UK, the legal embrace of the term "enlightened shareholder value", arguably widens the shareholders' interests and in so doing offers some support for the interests of other stakeholders. The extension of the directors' duty in promoting the success of the company to take into account the interests of other stakeholder groups forces a departure from exclusively looking after the shareholders and "has significant implications for the transformation of external company reporting beyond the financials of the annual accounts and reports".[77] In this light, accounting is more likely to "be regarded as a social practice rather than a purely technical matter of getting the numbers right".[78]

The IASB states in its Discussion Paper that other interest groups should receive separate reports to address their needs and that these should not be replaced by the management commentary. A justification for this suggestion is that if the management commentary were to cover all interests it would be too abstract and potentially too large so that the information sought is effectively obscured. Separate, more specific and direct reports ought to avoid that problem and, ideally, the management commentary should make cross-reference to those other reports as well as to the financial statements. Contrary to these arguments is the fact that, whilst in some jurisdictions such a practice may well arise, currently in the UK detailed social and environmental reports are still largely a matter of voluntary reporting[79] and the business review requirements stop short of guaranteeing the provision of such information, leaving it as a matter of decision by the directors if they consider it necessary for an understanding of the business.

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72 "Corporate responsibility reporting – ethics, profits and materiality", Radley Yeldar seminar, London, 15 November 2006, quoted in Tomorrow's Company, *The Future of Corporate Reporting – State of play* – February 2007, at www.tomorrowscompany.com, p. 14.

73 Tomorrow's Company, *The Future*, n. 72 above, p. 14.

74 Ibid., p. 13.

75 United Nations Environment Programme Finance Initiative (UNEP FI) Asset Management Working Group, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (2005), pp. 10–11: cited by B Horrigan, "21st century corporate social responsibility trends – an emerging comparative body of law and regulation on corporate responsibility, governance and sustainability" (2007) 4 *MqJBL* 85, at 108–9.

76 UNEP FI, *Legal Framework*, n. 75 above, p. 13.

77 Y Chahed, (Summer 2007) (13) *Risk and Regulation* (CARR Newsletter).

78 Ibid.

79 There are some discrete legislative provisions requiring information of this nature to be published such as can be found in s. 35 of the Pensions Act 1995 which requires pensions trustees to develop and act according to a statement of investment principles that records their policy on how they will exercise their voting rights and must "identify the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realization of investments".

It seems likely that debate will continue about who are the relevant users for the management commentary. It is clear that a wide range of constituents are interested in "accounting issues" as a matter for public regulation. There is also likely to occur "a re-negotiation of the boundaries between what accounting reports 'can' and 'should' do as competing groups define and advance their interests under the umbrella of 'accounting' as part of the legislative process".[80] In this light, the IASB may be required to offer a clearer justification for its investor focus. Not only does the IASB itself acknowledge a lack of empirical research on user needs, but also, as Collins et al. suggest, "significant value judgements of a political nature are involved . . . and this justification merely appears to reiterate traditional beliefs about the hierarchy of user needs".[81] Arguably, there is a possibility of change, but it seems unlikely in the near future. Instead, what can be concluded, is that the current focus on investor interests in the management commentary project merely deepens the narrow shareholder-centred orientation for corporate law. The IASB in this way contributes to a further convergence towards Anglo-American capitalism and system of corporate law and governance.[82]

7 Management to determine content of the management commentary

Aligned to the principles-based approach to management commentary, the IASB's Discussion Paper indicates that management should determine which information to include within the management commentary. As the IASB states,

> specifying disclosures for MC is more difficult than for information included in financial statements. The types of activities that are critical to an entity will be specific to that entity. As a consequence regulators have tended to identify the key elements that reflect the type of content they expect to see in MC rather than defining the elements themselves. Specifying a detailed list also encourages a "tick box" mentality, which should be avoided.[83]

Similarly, the IASB argues that management should also decide the best way to present the content.

> In our view, providing flexibility in both the presentation and content of MC, and using guidance to demonstrate that there are many ways to achieve the objective of MC, reduces the risk that preparers will use standard bland language, repeated year after year.[84]

The IASB states that it was influenced by the ASB's original proposed Reporting Standard 1, since it provided a helpful structure. Thus, the main elements to be contained within the management commentary in the opinion of the IASB include the nature of the business, the entity's objectives and strategies, its key resources, risks and relationships, its results and prospects, and its performance measures and indicators. Section 417(5) of the Companies Act 2006 gives to quoted companies more specific direction on the contents to be included in the business review though they only have to provide such details to the extent that they consider is necessary for an understanding of the development, performance or position of the company's business. The information identified is closely linked to the matters that directors must consider in the duty to promote the success of the company in s.172 of the Companies Act 2006. None of the specified matters to be included

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80 Chahed, *Risk and Regulaion*, n. 77 above.

81 W Collins, I Fraser and J Stevenson, *Response to IASB Discussion Paper on Management Commentary*, at www.iasb.org, at p. 3.

82 See Gallhofer and Haslam, "Exploring", n. 24 above, pp. 643–4.

83 Discussion Paper, n. 2 above, para. 97.

84 Ibid., para. 98.

are in fact compulsory, but, if they are not covered, the business review must state that fact. The subsection does not require an explanation why such matters are not covered but, arguably, the investors might expect an explanation if the business review is to be seen as a credible and worthwhile document.

The subsection is vague on the points it identifies for coverage and so what is to be included is left very open. So long as the information given can be considered to help in understanding the company's business development, performance or position then the directors may determine for themselves what information is provided. Such matters need only be included if necessary for an understanding of the business. The section gives no hint about what degree of understanding is needed or how directors should decide to what extent such matters are necessary to this understanding of the business. The directors are given power to decide not to disclose information relating to matters under negotiation, approaching developments or persons with whom the business has a relationship, if they consider that disclosure of such information would be seriously prejudicial to the company's interests or to the third person's and the public interests.[85] KPMG states that it is for companies to "select those KPIs that will succinctly demonstrate to members the development, performance and position of the business"; seeking additional assurance for KPIs might protect the company from inconsistent calculations; the KPIs used should be what the board is already monitoring and they should be aligned to strategies, objectives and risks; the most relevant KPIs are likely to be reviewed at each board meeting; and there will usually be five or six relevant KPIs.[86]

The IASB concluded that any IASB standard or guidance on management commentary should not specify the performance measures or indicators that entities should disclose. The IASB adopts the view that the ASB's approach reflects the principle that the management commentary should be through the eyes of management and so "the onus is on management to determine which performance measures and indicators, and how many, reflect best what is required for an understanding of the business".

The effect of this managerial discretion within the IASB and UK approaches, together with their principles-based approach, is likely to result in a lack of comparability among reports, arguably because the provisions are too broad and vague. Alternatively, over time a degree of consensus may develop about what might be expected. The IASB indicates that future guidance is likely to be required to provide more definitive guidance to standardise various non-IFRS financial performance measures and other non-financial performance measures and indicators. One reason for defining measures used is to facilitate comparison between entities and greater consistency in reporting by those entities that regard each measure as important. Yet, this might result in an impression of uniformity as boards

85 Subs. (10) and (11).

86 Smith & Williamson Solomon Hare highlight possible examples. Financial KPIs might include: gross profit margins; net operating margin; return on capital employed; gearing/interest cover; sales growth; sales per employee; sales per square foot; operating cash flow; liquid asset ratio; hire income as a percentage of fleet cost. The following are possible non-financial KPIs: market share; number of subscribers; customer retention; new business from existing customer referrals; environmental spillage; waste disposal; CO_2 emissions; employee health and safety; accident statistics; staff satisfaction levels; staff retention levels; efficiency (complaints as percentage of total output). KPMG makes a number of suggestions in its publication relating to scene-setting; objectives of the company; strategy; risks and uncertainties; measurement; performance; and forward-looking information. Apart from these broad contents, KPMG also suggests that the business review should contain the following features: that it reflects the directors' viewpoint; that it provides matters of relevance to the members; that it provides forward-looking information; that it complements and supplements the financial statements; that it is comprehensive and understandable; that it is balanced and neutral; and that it is comparable over time: KPMG, *The Directors' Report and the Business Review* (London: KPMG LLP 2006), at www.kpmg.co.uk/pubs/302810.pdf (last accessed 15 September 2008).

adhere strictly to the guidelines issued by bodies such as the ASB or of large accounting firms such as KPMG.[87] This would not then be very different from the box-ticking culture that these measures in fact aim to avoid. A further restriction may emerge from directors' potential liability for the information they publish.

8 Potential liabilities of directors arising from the management commentary

The management commentary, as a corporate governance report, has the objective of enabling shareholders to assess how well the directors have performed in their duty to promote the success of the business. One of the main challenges in the development of management commentary containing forward-looking information is the issue of potential liability. The shareholders might be able to challenge the directors on the basis of the information disclosed in the management commentary, not only with regard to their duty to promote the success of the company but also for inaccurate information.

In its Discussion Paper, the IASB notes that the regulatory or legal environment influences how and the extent to which management commentary is oriented towards the future. The IASB also observes that in some jurisdictions there are safe-harbour provisions to restrict liability claims or regulatory provisions, or both, that require cautionary statements relating to forward-looking information.[88] The IASB does not express a preference for any particular liability regime. In the UK, the Companies Act 2006 has clarified the position with regard to liability for false or misleading statements in reports in s. 463. These provisions impose on directors liability for statements in the directors' report, directors' remuneration report and any summary financial statement derived from those reports which are untrue or misleading and are made with the knowledge that they are untrue or misleading or the director was reckless as to whether they are untrue or misleading. Similarly, a director will be liable for omissions which he or she knows to be dishonest concealment of a material fact. In such circumstances, the director is liable to compensate the company for losses suffered as a result of relying on the report. Directors will not be liable for statements made in good faith, even if they turn out to be untrue or misleading. Under the legislation, issuers will be liable to an individual investor or other third party only if that party has reasonably relied on the statement for investment purposes, and suffered loss as a result of the statement or omission. The UK provisions restrict directors' liability not only in relation to forward-looking statements but also in relation to statements made in narrative reports generally.

Although the IASB does not directly make the connection, a related point of view that it expresses is that all the information contained within management commentary is supportable,[89] and where there is uncertainty the management commentary should contain a cautionary note to ensure that users are made aware of such areas of uncertainty, in particular with forward-looking information.[90]

9 Current reporting practice in the UK and implications for the IASB's project

The existence of a regulatory framework on management commentary reports is likely to give rise to greater amounts of disclosure by companies compared with companies

87 Already in the UK the appearance of uniformity has been observed: Deloitte Touche, *Written to Order: Surveying OFRs, EBRs and narrative reporting in annual reports* (2007), at www.deloitte.co.uk.

88 Discussion Paper, n. 2 above, para. 57.

89 Ibid., para. 75.

90 Ibid., para. 76.

following voluntary guidelines applying to such reports.[91] This observation suggests that if the IASB's project results in a reporting standard among the IFRS this will generate publication of more company information to investors.

In the UK, Pricewaterhouse Coopers suggests that the introduction of the enhanced business review requirements has brought about improved communication of strategic priorities, KPIs and risk.[92] They note, similarly with Yun Seah and Tarca, that the scope and nature of information disclosed have improved, but there remains room for improvement in the quality of information reported. The legislation that currently exists in the UK is new and so there is still time for new reporting practices to be established. In addition, its high-level nature leaves room for different interpretations to be made. The Reporting Statement of Best Practice acts as a guide, but this does not have to be followed. Without alternative guidance to the legislation, however, it seems likely that, increasingly, companies will rely on the Reporting Statement as the basis for shaping and developing their narrative reports. As time goes on, assessments by professional bodies and practitioners may also develop a basis for measuring compliance with the legislation, but at this early stage the line between compliance and good practice is not clearly drawn. Nor, indeed, is the line between compliance and non-compliance with the legislation. There are indications that large companies are taking their responsibilities seriously. The new requirements have resulted in a general lengthening of annual reports and there is emerging an appearance of uniformity. On the other hand there are variations in the number and types of KPIs described.

The IASB looks set to continue its work on the management commentary and initial signs suggest that a guidance document will be developed with a principles-based approach. The IASB's project will probably not make a huge difference to practice being developed in the UK other than to consolidate what has been achieved so far. By and large, the broad principles identified by the IASB match those of the UK and both the IASB and the UK identify the same primary users, both support managerial discretion and both advocate publication of future-oriented information. However, for the IASB's project more broadly, the prospects of success in achieving comparability and international convergence are more open to question. This leads me to some more general conclusions.

Conclusions

A number of general conclusions can be offered. First the prospects of achieving an international standardisation of provisions for management commentary are open to debate. Although there are many similarities in approach and principles among many of the jurisdictions examined by the IASB in its research on management commentary, still there are significant differences between the arrangements in those jurisdictions. Some jurisdictions do not require any form of management commentary. Thus, to introduce new rules to those jurisdictions will potentially meet with political and cost barriers. Even if a general formal standard were adopted, especially if presented in the form of general principles, the different interpretations and forms of implementation likely would be a major obstacle to achieving a standardised practice internationally. Zeff reminds us that the obstacles to achieving convergence include problems of interpretation, language and

91 S Shi Yun Seah and A Tarca, "The impact of regulatory framework on management commentary reports", Working Paper, Version 28, February 2007, available on ssrn papers network Scholar, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962628 (last accessed 15 September 2008).

92 Pricewaterhouse Coopers LLP, *Show Me More than the Money – An assessment of how prepared companies are for the business review* (London: Pricewaterhouse Coopers LLP 2006) and Pricewaterhouse Coopers LLP, *Business Review: Has it made a difference – a survey of the narrative reporting practices of the FTSE 350* (London: Pricewaterhouse Coopers LLP 2007).

terminology.[93] These are formidable hurdles to a genuine international convergence of regulatory arrangements or corporate practice. In any event, the depth of international convergence also remains debateable.

Not only do episodes such as the European carve-out of certain IFRSs, such as IAS 39, put into doubt the sincerity of the push towards convergence, but cultural differences and continuing competition for capital investments encourage continuation of a degree of regional protectionism. The American stance, indeed, gives rise to those suspicions. The supposed relaxation of the US insistence on rules-based accounting regulation in the wake of Enron hardly rings true when the key regulatory response to Enron was the introduction of the Sarbanes-Oxley Act which was characterised strongly by rigid rules-based requirements. The apparent change of heart was almost certainly a response to the threat of companies de-listing from US stock markets[94] rather than a rejection of the rules-based approach to regulation.

The IASB has been accused of having over-simplified its work in the past and at this stage its contribution to the debate on management commentary is also basic and superficial. In the UK, debates over the OFR were long, heated and complex. This was demonstrated by the withering response to the Chancellor's announcement to scrap rules for the OFR towards the end of 2005, in which he attempted to offer to the business community a reprieve from regulatory burdens. Many in the business community actually sought some form of business review requirement and the EU legislation had already laid the foundation for enhanced narrative reporting. Another aspect of the complexity within the business review requirement was that related to potential liability and, again, this was debated heatedly in the UK. Yet the IASB offers no way forward on this point in its Discussion Paper.

The narrow version of capitalism that the IASB's proposed management commentary supports, in particular, an investor-centric view of the company, may well encourage the US regulators to go along with it. What makes the IASB's work on the management commentary potentially more palatable in the more immediate future is its principles-based stance since this, as noted above, allows for a degree of flexibility. Yet the problems of uncertainty and possible limitations to investor protection this stance may entail will also have to be faced.

The UK's experience relating to business review requirements is so far relatively positive. However, these are still early days and more research into the reporting practices of companies and how those reports are received and used by their recipients is essential. Longer reports do not guarantee better quality. Effective communication requires a true and potentially costly dialogue that risks regulatory capture. The real test on the effectiveness of the communication is to be measured by the companies' results and their investor relations. The IASB should follow the UK's experience closely as this may have lessons for the international business community. In turn the input of other jurisdictions and debates in the IASB may also inform how our legislation is to be utilised and potentially altered. At the very least, the IASB's work is likely to give greater impetus to the work of organisations such as the enhanced business reporting consortium,[95] which has been developing an enhanced business reporting framework.

93 S A Zeff, "Some obstacles to global financial reporting comparability and convergence at a high level of quality" (2007) 39 *British Accounting Review* 290–302.

94 See further, A Bhimani, "The role of a crisis in reshaping the role of accounting" (2008) 27 *Journal of Accounting and Public Policy* 444–54.

95 www.ebr360.org.

Management commentary is firmly recognised as an essential aspect of corporate governance. How it is to be developed internationally though is still to be settled and the only prediction that can be made with any certainty is that the debate will be long and complex.

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The end of "comply or explain" in UK corporate governance?

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Introduction

It is a truism to say that recent financial crises have seriously undermined public confidence in the City of London. At the close of the 21st century's first decade, the Victorian belief that the "gentlemanly capitalists" of EC1 can be relied upon to keep their own proverbial house in order is more tenuous than ever. There is a tendency to view the degeneration of public faith in securities markets as a relatively recent phenomenon triggered by the apparent excesses and irresponsibility of the post-1980s era. However, the City has to varying extents always been perceived as an opaque and murky environment to many outsiders, and the history of corporate and financial regulation in the UK can best be depicted as an ongoing contest between: on the one hand, institutional investors and boards favouring the preservation of operational flexibility and dynamism; and, on the other, a democratic state striving to ensure the public accountability of a sector whose activities have profound (albeit seldom understood) implications for the country's "real" economy and society.[2]

The tension between these two regulatory goals has been nowhere more conspicuous than in the field of corporate governance, which is defined here as the problem of holding key executive decision-makers in listed companies accountable for their actions. It is arguably in this controversial area that the above flexibility/accountability trade-off has posed the most intractable difficulties for policy-makers. At the same time, though, this area could also be said to highlight the alleged international comparative advantage of the so-called "London Approach" to financial market regulation most succinctly. Indeed, in a recent document produced by the UK Financial Reporting Council (FRC) as part of the "City of London – City of Learning" initiative, it was recounted that the City of London "has a history of encouraging free trade and good corporate governance, based on the application of simple principles to the individual and distinct circumstances of each

1 I am grateful for comments received from participants at the ESRC/World Economy and Finance Programme Colloquium "The Globalisation of Corporate Governance? Reform pressures and processes in an era of financial crises" held at Queen's University Belfast in September 2008. The usual disclaimer applies. An earlier and shorter version of this paper was published in the *Journal of Securities Law, Regulation and Compliance* (2(1), November 2008) under the title "Averting the overprescription of UK corporate governance norms".

2 For an argument to this effect in relation to the development of the US system of corporate and financial regulation, see D A Skeel, *Icarus in the Boardroom: The fundamental flaws in corporate America and where they came from* (Oxford: OUP 2005).

entity".[3] By strongly resisting the governmental temptation to control for every conceivable contingency, while relying to a significant extent on capital market participants themselves to formulate and police the "rules of the game" in their collective self-interest, the UK is widely regarded to offer a uniquely cost-effective framework of quasi-legal controls in respect of crucial business and financial issues.

At the heart of this innovative financial–regulatory model is the Combined Code on Corporate Governance,[4] which has underlain the UK's system of corporate governance since its inception (in an earlier form) at the beginning of the 1990s.[5] In contrast to the formal, extensive and detailed catalogue of governance rules imposed on US-listed companies under the 2002 Sarbanes-Oxley Act,[6] the UK has succeeded in preserving a set of corporate governance norms that are non-legally binding in form, relatively broad-based in substance, and readily comprehensible by boards without the need for extensive professional assistance.[7] Arguably the most crucial factor underlying the Combined Code's comparative advantage in the above regards is the principle of "comply or explain", by virtue of which UK-listed companies are exempted from the need to adopt a prescriptive "one-size-fits-all" model of internal organisational control. In theory, this novel regulatory technique permits a company to opt out, in effect, from any one or more requirements of the Code that its board considers to be cost-ineffective or otherwise inappropriate for that company's specific circumstances. At the same time, and as a condition of listing on the London Stock Exchange (LSE), any such deviation from standard governance practice must be explained to investors within the company's annual accounts and reports. This mandatory disclosure obligation underpins the Code and has the effect of setting Code compliance as the general "default" position for listed companies in the absence of strong countervailing considerations. The Code is consequently vested with sufficient coercive clout to represent a credible managerial "bonding" mechanism in the eyes of institutional investors, thus (theoretically at least) ensuring the preservation of a level of trust conducive to the continuing provision of public equity capital to companies on desirable terms.[8]

In spite of the generally positive reception that the "comply or explain" principle has received within both the investor and directorial communities in the UK over the past decade and a half, however, some serious doubts remain as to whether the central promise of "comply or explain" – namely its purported capacity to ensure an efficient balance between (a) ensuring governance best practice and (b) nurturing board flexibility and diversity – is being effectively achieved in practice. As this article will seek to demonstrate, there has occurred over recent years a progressive growth in detail and rigidity of some of

3 FRC, *The UK Approach to Corporate Governance* (London: FRC November 2006).

4 The most recent (June 2008) edition of the Combined Code is available on the website of the UK FRC: www.frc.org.uk/corporate/combinedcode.cfm.

5 See *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report) (London: Gee & Co. December 1992).

6 The Public Company Accounting Reform and Investor Protection Act of 2002 (otherwise known as the Sarbanes-Oxley Act) was enacted on 30 July 2002. Its shorthand name is a reference to the Democrat and Republican (respectively) Senators Paul Sarbanes and Michael G Oxley, who sponsored the Bill's introduction before the US House of Representatives.

7 On this, see FRC, *UK Approach*, n. 3 above.

8 On the role of financial regulation in "bonding" the expectations of public investment markets, see two articles by J C Coffee, "Law and the market: the impact of enforcement" (2007) 156 *University of Pennsylvania Law Review* 229 and "The future as history: the prospects for global convergence in corporate governance and its implications" (1999) 93 *Northwestern University Law Review* 641; and three articles by R La Porta, F Lopes-De-Silanes, A Shleifer and R Vishny, "Investor protection and corporate governance" (2000) 58 *Journal of Financial Economics* 3, "Legal determinants of finance" (1997) *Journal of Finance* 1131 and "Law and finance" (1998) 106 *Journal of Political Economy* 1113.

the Code's key Principles and Provisions, which has consequently rendered the Code susceptible to a formulaic and legalistic interpretation both by financial market and corporate actors. This is particularly so in relation to Principle A.2 of the Code, which regulates the controversial issue of the division of leadership responsibilities (DoLR) between the company's chair and chief executive officer (CEO).[9] The problematic application of this Principle today is highlighted by reference to the recent controversy surrounding the British retailer Marks & Spencer plc (M&S), whose decision to promote its current CEO, Sir Stuart Rose, to the dual office of executive chair effective from 2008 onwards was met with widespread investor hostility. It will be submitted that the M&S fallout highlights the potential for intractable "clashes" to occur between seemingly equally ranking Code norms. Such clashes stem ultimately from the formalistic and "closed-ended" nature of Principle A.2 following its reform by the Higgs Committee in 2003,[10] and are a source of costly and potentially divisive confusion for investors and boards alike.

The first part of this paper provides a brief historical account of the development of the "comply or explain" principle since its inception in the UK in 1992. The second part documents the recent tendency towards over-prescription of the Code's key norms as demonstrated by the Marks & Spencer fallout. The third part suggests potential regulatory solutions to the above problems aimed at counteracting the diminishing practical relevance of the "comply or explain" doctrine in UK corporate governance. The fourth part concludes.

A short history of the "comply or explain" doctrine

The principle of "comply or explain" was pioneered in the landmark 1992 report by Sir Adrian Cadbury's Committee on the Financial Aspects of Corporate Governance.[11] As the basis for its inaugural Code of Best Practice on governance, the Cadbury Committee proposed a system of voluntary compliance by corporate boards with certain recommended norms of best practice, backed up by a mandatory disclosure requirement to be contained in UK Listing Rules.

All listed companies registered in the UK were accordingly urged to comply with the Code's initial nineteen provisions covering the four overarching (and overlapping) issues of the board of directors, non-executive directors, executive directors, and reporting and controls. In respect of each relevant company, the board was required to make a statement about the firm's compliance with the Code as part of their annual directors' report, and, in the event of non-compliance with any one or more provisions, to provide supporting reasons for the deviation(s) from the Code. Meanwhile, institutional shareholders and/or their professional advisors were encouraged to use their ownership influence to pressurise companies towards compliance with the Code's provisions.

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9 See Combined Code, n. 4 above, pp. 6–7.

10 See *Review of the Role and Effectiveness of Non-executive Directors* (Higgs Report) (London: DTI January 2003).

11 Cadbury Report, n. 5 above.

This novel "soft"[12] approach was justified on the basis that a mandatory and legalistic set of standards would be likely to encourage a perfunctory form of compliance by companies with the "minimum standard", whereby boards and their legal advisors would aim to satisfy the strict letter of the law while nevertheless negating the committee's key policy goals.[13] The Cadbury Committee members were also very keen to enable a degree of "flexibility in implementation" of the Code,[14] and emphatically rejected the notion that they should take a uniform, one-size-fits-all approach to prescribing what constitutes an appropriate governance system for any company. Accordingly, the Cadbury Committee recommended that "[t]he Code [should] be followed by individuals and companies in the light of their own specific circumstances . . . and in interpreting it they should give preference to substance over form".[15]

When the Cadbury Committee's recommendations underwent their first comprehensive review in 1998, the over-riding concern of Sir Ronnie Hampel's review committee was "the need to restrict the regulatory burden on companies, and to substitute principles for detail wherever possible".[16] This necessitated a reconfiguration of the balance that had previously been achieved between the dual criteria of compliance and flexibility, with the Hampel Committee recommending an increased emphasis on the latter goal and a correspondingly reduced focus by boards on ensuring "blind" compliance with the Code absent proper regard for the particular circumstances of the relevant company. As the Hampel Committee explained:

> Good corporate governance is not just a matter of prescribing particular corporate structures and complying with a number of hard and fast rules. There is a need for broad principles. All concerned should then apply these flexibly and with common sense to the varying circumstances of individual companies.[17]

The Hampel Committee accordingly recommended a significant change in the process whereby companies report to shareholders and the public on their record of

12 The term "soft" denotes that the Code's substantive provisions are, in practical terms, applicable and enforceable on a purely voluntary basis. However, this does not mean that they are self-regulatory in nature. Rather, the fact that the Code's application is underpinned by a mandatory disclosure obligation contained in UK Listing Rules demonstrates that, on a formal level, the foundation of the Code's coerciveness lies in the UK Listing Authority's delegated statutory powers to enforce the underlying conformance–disclosure obligation, without which the Code's practical impact would almost certainly be nullified. At the time of the Cadbury Code's inception in 1992, the UK Listing Authority was the LSE. However, contemporaneously with the inception of the first Combined Code on Corporate Governance in 2000, the LSE was replaced in this role by the then newly formed FSA, whose enforcement powers were considerably stronger than those of its predecessor. In respect of form, therefore, the Combined Code could be said to represent a notably "harder" body of rules than those contained in the earlier Cadbury Code of Best Practice. Adopting Professor Melvin Eisenberg's terminology, the Combined Code is accordingly best described as a body of "organisational rules" which, although not legal rules in the standard sense of the term, nevertheless "tend to operate in many ways like legal rules" insofar as they are "adopted by private organizations" (in this case, the UK's FRC) and also are "directly or indirectly backed by formal sanctions". See M Eisenberg, "Corporate law and social norms" (1999) 99 *Columbia Law Review* 1253, at 1255–6. On the distinction between the terms "self-regulatory" and "voluntary" in this context, see E Wymeersch, "The enforcement of corporate governance codes" (2006) 6 *Journal of Corporate Law Studies* 113, at 114.

13 Cadbury Report, n. 5 above, at para. 1.10.

14 Ibid.

15 Ibid., at para. 3.10.

16 *Committee on Corporate Governance (Final Report)* (Hampel Report) (London: Committee on Corporate Governance and Gee Publishing January 1998), para. 1.6.

17 Ibid., para. 1.11.

conformance[18] with the Code's Provisions, together with a complementary alteration to the Code's underlying structure, both of which were subsequently adopted within the first Combined Code on Corporate Governance in 2000.[19]

On the basis of Hampel's suggestions, the Code was divided into two different but adjoining levels of prescription, comprising seventeen relatively open-ended Principles supplemented by a larger number of more detailed explanatory Provisions. Companies were from then onwards required by Listing Rules to produce a two-part corporate governance statement in their annual reports and accounts, explaining: first, in broad and narrative terms, how they *apply* the higher-level Principles of the Code, detailing the particular governance policies that the board has adopted in order to implement those Principles within the specific and current circumstances of the company's business;[20] and, secondly, whether the company *complies* with all of the more specific lower-level Provisions of the Code, together with supporting reasons in the event of non-compliance with any one or more of those Provisions.[21]

In the more recent editions of the Code which followed the publication of the Higgs[22] and Smith[23] reports in 2003, the compliance task has been further complicated with the insertion of a third layer of norms into the Code's basic regulatory structure. As a result, boards are today faced with a three-pronged structure of high-level Main Principles, mid-level Supporting Principles and low-level Provisions. Curiously, the Code contains no express guidance on the precise interaction between these three levels of norm, besides simply reiterating the continuing Listing Requirement for companies to explain how they apply the first category of norms together with their record of conformity with the final category. The rather open-textured wording of the Supporting Principles, however, would suggest that they are of purely illustrative value in relation to each of the Code's Main Principles.

Since its inception in the Cadbury Committee's inaugural recommendations sixteen years ago, the "comply or explain" principle has been exported from the UK to provide a basis for numerous other countries' corporate governance systems, including those of Australia, Canada, Mexico, the Netherlands, Singapore, and, to a very limited extent, even the Unites States.[24] More recently, the concept has been adopted as a basis for fledgling

18 In this context, "conformance" is not synonymous with "compliance". Rather, conformance with the Code can be achieved either by complying with all of its constituent provisions, or alternatively by providing an explanation for non-compliance with any provision(s). In this specific sense, the term "conformance" is attributable to a recent report by the Hedge Fund Working Group, in which it promulgated a set of self-regulatory standards of best practice for hedge funds based on the "comply or explain" principle. See *Hedge Fund Standards: Final report* (Hedge Fund Report) (London: Hedge Fund Standards Board January 2008), para. 3.6.

19 *The Combined Code: Principles of best practice and code of best practice* (London: FRC May 2000). This development also coincided with the transfer of responsibility for enforcing the Code's underlying conformance–disclosure obligation from the formerly self-regulatory LSE to the FSA, so that the Code was in effect transformed from a "private sector initiative" to an institution exhibiting something of a quasi-public character. See E Ferran, "Corporate law, codes and social norms – finding the right regulatory combination and institutional structure" (2001) 1 *Journal of Corporate Law Studies* 381, at 396.

20 Although the Preamble to the most recent (2008) edition of the Code confirms existing common board practice by providing that, where a company is fully compliant with the Code's Provisions, it need only report the fact of full compliance in its annual corporate governance statement. See Combined Code, n. 4 above, Preamble, at para 4.

21 This dual disclosure requirement is today laid down by Listing Rule 9.8.6 (5)–(6), which is contained in the official *Handbook* of the UK Listing Authority, the FSA.

22 Higgs Report, n. 10 above.

23 See *Audit Committees: Combined Code guidance* (Smith Report) (London: FRC January 2003).

24 P Coombes and S Wong, "Why codes of governance work" (2004) 2 *McKinsey Quarterly* 48, at 51.

programmes of self-regulation by financial industry bodies both in the UK and beyond, including the Walker Working Group's influential guidelines on disclosure and transparency in the UK's private equity sector,[25] and also the newly established Hedge Fund Working Group's report on standards of best practice for hedge funds.[26]

Overall, then, it suffices to say that the Cadbury Committee's brainchild of "comply or explain" has come a long way within its relatively short existence.

The problem of over-prescription of code norms

One of the most common criticisms levelled at the Combined Code over recent years is the charge that it has become too detailed and prescriptive in form. In particular, there is a view that the 2003 revisions to the Code suggested by the Higgs Committee on the role and responsibilities of non-executive directors (NEDs)[27] represented an unjustified "knee-jerk" reaction to some well-publicised supervisory failures in US and continental European companies.[28] This arguably has had the effect of increasing the prescriptiveness and rigidity of the Code at the expense of its reputed flexibility. One critic, for instance, has argued that Higgs "introduced so many requirements that it is simply legislation by the back door",[29] while others have described recent developments in UK corporate governance in terms of a process of "regulatory creep" whereby improvements in governance occasioned by codes encourages people to broaden their scope and also increase their level of detail.[30]

THE DIVISION OF LEADERSHIP RESPONSIBILITIES DOCTRINE

A notable example of this process of regulatory creep in action can be observed in relation to the controversial Code provision on the separation of the respective offices of the company's chair and CEO.[31] It is a generally accepted principle of British corporate governance today that the dual responsibilities of (a) leading the running of the company's business and (b) chairing meetings of the company's board of directors are (within listed companies at least) logically separate tasks that each fall to be performed by different corporate officers. The former task is accordingly the job of the company's CEO. The latter responsibility meanwhile should normally be vested in a specialist non-executive chair. While the chair is typically expected to set the agenda for and lead the deliberations of the company's board during formal periodic meetings,[32] he or she should not be involved at all in the company's day-to-day operational management affairs. Vice versa, while the CEO

25 See Walker Working Group, *Guidelines for Disclosure and Transparency in Private Equity* (November 2007), available at http://walker-gmg.co.uk/sites/10051/files/wwg_report_final.pdf; Walker Working Group, *Disclosure and Transparency in Private Equity* (Consultation Document, July 2007), available at http://walker-gmg.co.uk/sites/10051/files/walker_consultation_document.pdf.

26 See Hedge Fund Report, n. 18 above; H McVea, "Hedge fund regulation, market discipline and the Hedge Fund Working Group" (2009) 4 *Capital Markets Law Journal* 63.

27 Higgs Report, n. 10 above.

28 See e.g. A Alcock, "Higgs – the wrong answer?" (2003) 24 *Company Lawyer* 161.

29 Arthur Piper (internal auditor), cited in S R Arcot and V G Bruno, "One size does not fit all, after all: evidence from corporate governance" (2007) London School of Economics Working Paper, p. 35, n. 9.

30 Coombes and Wong, "Why codes", n. 24 above, p. 52.

31 Combined Code, n. 4 above, Code Provision A.2.1.

32 On the general role and functions of the chair, see Combined Code, n. 4 above, Supporting Principle A.2; Higgs Report, n. 10 above, ch. 5; Sir A Cadbury, *Corporate Governance and Chairmanship: A personal view* (Oxford: OUP 2002).

should wield ultimate authority in the normal course of management affairs, he or she must temporarily cede this authority to the chair on entering board meetings.[33]

Although prima facie counter-intuitive, this arrangement is said to fulfil a crucial dual function. In the first place, the division of leadership responsibilities (DoLR) on the board theoretically "neutralises" the dominance of the CEO during intermittent meetings, thereby providing a temporary "window" through which other less senior corporate officers can (on the invitation of an impartial chair) tender potentially dissenting opinions on key strategic issues unencumbered by the firm's pre-existing authority structure.[34] In this way DoLR improves the overall cognitive capacity of the board by ensuring that its deliberations and decisions are reflective of a broad body of opinion as opposed to emanating ultimately from the CEO personally.[35] And, secondly, DoLR theoretically enables the board to operate as a robust and credible monitoring mechanism – in other words, a forum for supervising and disciplining underperforming managers – by ensuring that ultimate control over its deliberations is vested in an officer other than one of the senior management team themselves. Accordingly, the board becomes an objective and, to some extent, "external" body which managers *submit themselves to* for periodic appraisal and sanction.[36]

The fact that DoLR is a generally accepted corporate governance norm in the UK does not mean, however, that it is universally accepted. For instance, in the United States, which has a markedly similar corporate governance system to Britain characterised (to an even greater extent than the UK) by widely dispersed ownership via a liquid stock market, it is customary for large listed corporations to combine their dual management and board leadership functions under the remit of a unitary executive chair.[37] Further, over recent years some commentators have begun to laud the more streamlined board structures exhibited by those formerly listed companies that are taken under private equity ownership, which typically combine the responsibilities of corporate and board leadership in order to achieve a distinct and concentrated strategic focus.[38] Finally, even some well-known British listed companies have made the considered decision to refrain from applying the DoLR for

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33 Sir Adrian Cadbury explains that "at the board meeting the chief executive is no longer [the management team's] executive head, but *primus inter pares*, first among equals"; Cadbury, *Corporate Governance*, n. 32 above, p. 112.

34 See M Mace, *Directors: Myth and reality* revised edn (Cambridge Mass: Harvard Business School Press 1986 (first published 1971)); R Morck, "Behavioral finance in corporate governance – independent directors and non-executive chairs", Harvard Institute of Economic Research Discussion Paper No. 2037 (April 2007).

35 On the danger of "groupthink" developing within a board which contains a dominant authority figure (e.g. an autocratic CEO), see Morck, "Behavioral finance", n. 34 above; D C Langevoort, "The human nature of corporate boards: law, norms, and the unintended consequences of independence and accountability" (2001) 89 *Georgia Law Journal* 797.

36 On the role of the board as an accountability and monitoring mechanism, see M C Jensen and W Meckling, "Theory of the firm: managerial behaviour, agency costs and ownership structure" (1976) 3 *Journal of Financial Economics* 305; M Eisenberg, *The Structure of the Corporation: A legal analysis* (Boston: Little, Brown & Co. 1976), pp. 140–8; J N Gordon, "The rise of independent directors in the United States, 1950–2005: of shareholder value and stock market prices" (2007) 59 *Stanford Law Review* 1465, at 1510–40; R C Nolan, "The legal control of directors' conflicts of interest in the United Kingdom: non-executive directors following the Higgs Report" in J Armour and J A McCahery (eds), *After Enron: Improving corporate law and modernising securities regulation in Europe and the US* (Oxford: Hart Publishing 2006), ch. 11.

37 Cadbury, *Corporate Governance*, n. 32 above, p. 104.

38 See e.g. M C Jensen, S Kaplan, C Ferenbach, M Feldberg, J Moon, B Hoesterey, C Davis and A Jones, "Morgan Stanley roundtable on private equity and its import for public companies" (2006) 18 *Journal of Applied Corporate Finance* 8; M C Jensen, "The economic case for private equity (and some concerns) – pdf of keynote slides", Harvard NOM Research Paper No. 07-02 (November 2007); F Guerrera and J Politi, "Private equity: life on the other side", *Financial Times*, 24 April 2007.

varying periods of time due to its perceived "ill-fit" with the company's current strategic circumstances or path-dependent management culture.[39]

The Cadbury Committee in 1992 recommended that "the chairman's role . . . should *in principle* be separate from that of the chief executive".[40] The Cadbury Code therefore stated that "[t]here should be a clearly accepted division of responsibilities at the head of the company, which will ensure that no one individual has unfettered powers of decision".[41] The Cadbury Code further provided that, in those cases "[w]here the chairman is also the chief executive, it is essential there should be a strong and independent element on the board, with a recognised senior member".[42] However, the Cadbury Committee refrained from laying down any definite requirement as to separation of the chair and CEO positions, leaving the decision ultimately up to boards themselves in the light of the company's specific circumstances and strategic challenges.

In a similar vein, the Hampel Committee in 1998 opined "that, other things being equal, the roles of chairman and chief executive officer are better kept separate", although the committee acknowledged that "a number of companies have combined the two roles [of chair and CEO] successfully, either permanently or for a time".[43] While the ensuing 2000 version of the Combined Code emphasised that "the running of the board" and "the running of the company's business" were the "two key tasks at the top of every public company",[44] the Code notably did not recommend that these functions should each be performed by separate officers in all companies. In fact, the only seemingly absolute expectations of boards in this regard established in the 2000 Code were that they: (a) publicly justify any decision to combine the chair and CEO positions in one person; and (b) ensure that they contain a robust independent non-executive element, in particular by appointing a special senior NED to act as the focal point for NEDs' concerns in respect of the combined chair/CEO office and its consequences for the board.[45]

In spite of the somewhat ambivalent tone of Cadbury and Hampel's recommendations on the issue of the chair/CEO split, the committees' basic affirmative view on the matter nevertheless quickly became recognised as a highly influential tenet of British corporate governance best practice. From a study of 250 randomly selected UK-listed companies, conducted between 1998 and 1993, Franks, Mayer and Renneboog discovered that the chair/CEO roles were combined in 32 per cent of firms.[46] But a further study by Conyon

39 Notable examples from recent years include Wm Morrison Supermarkets plc, ITV plc, and M&S plc (on the last of which, see below).

40 Cadbury Report, n. 5 above, para. 4.9 (my emphasis added).

41 Ibid., para. 1.2.

42 Ibid.

43 Hampel Report, n. 16 above, para. 3.17.

44 *The Combined Code: Principles*, n. 19 above, Principle A.2.

45 Ibid., Code Provision A.2.1. The Hampel Report in fact went further than this and recommended that a senior NED should be identified in a company's annual report in any event, both for those companies that split the chair/CEO positions and those that did not. See Hampel Report, n. 16 above, para 4.5.

46 J Franks, C Mayer and L Renneboog, "Who disciplines bad management?" (1998), cited in C Mayer, "Corporate governance in the UK", in *Corporate Governance and the Reform of Company Law*, Hume Papers on Public Policy, vol. 8, no. 1 (Edinburgh: Edinburgh UP 2000), p. 1, at p. 5.

and Mallin found that, just two years after Cadbury's initial recommendations (in 1994), this figure had been reduced to 14.2 per cent.[47] Moreover, later data presented by MacNeil and Li showed that, in 2004, only 8 per cent of FTSE All Share companies (excluding investment trusts) were recorded as combining the two offices.[48]

The general success of these early recommendations in engendering near-universal separation of the chair/CEO functions on listed company boards did not, however, discourage the Higgs Committee from asserting a notably more resolute line on the matter in the 2003 version of the Code, the relevant part of which has subsequently been adopted full-scale in the 2006 and (current) 2008 versions.[49] Main Principle A.2 of the current Code, which deals with the issue of the chair and CEO, represents a progression from its post-Hampel predecessor insofar as it now affirmatively recommends "a clear division" between the dual responsibilities of board and executive leadership, as opposed to the Hampel Committee's requirement that any lack of such division be supported merely by a reasoned justification plus effective "back-up" arrangements. Supporting Principle A.2, meanwhile, re-enforces this basic position by offering a brief description of the chair's specialist responsibilities in the former of those regards.

The most definite assertion of the DoLR doctrine, though, is Code Provision A.2.1, which states unequivocally that "[t]he roles of chairman and chief executive *should not be exercised by the same individual*", and that "[t]he division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board".[50] Code Provision A.2.2 firmly establishes, moreover, that "[a] chief executive should not go on to be chairman of the same company".[51] The only slight degree of leeway for boards on this issue is provided by the latter of those Provisions, which stipulates that "[i]f exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of appointment and in the next annual report".[52]

The M&S fallout

The Higgs Committee's decision in 2003 to place the DoLR doctrine on a firmer prescriptive footing within the Code is understandable, given that its review was commissioned in the imminent wake of the Enron and Worldcom catastrophes in the United States when considerations of managerial accountability and NEDs' supervisory

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47 M Conyon and C Mallin, "A review of compliance with Cadbury" (1997) 2 *Journal of General Management* 24, cited in Mayer, "Corporate governance", n. 46 above. Further, an empirical study into the impact of UK corporate governance codes from 1992 to 1999 recorded a significant increase during this period in the proportion of surveyed FTSE 350 NEDs specifying "the powers, role and responsibilities to be delegated to individual directors – especially to the chairman and managing director". See K Gay, "A boardroom revolution? The impact of the Cadbury nexus on the work of non-executive directors of FTSE 350 companies" (2001) 9 *Corporate Governance: An international review* 152, at 156.

48 I MacNeil and X Li, "'Comply or explain': market discipline and non-compliance with the Combined Code" (2006) 14 *Corporate Governance: An international review* 486, at 489, drawn from data collected by PIRC in its Corporate Governance Annual Review 2004. See also Rt Hon Lady Justice Arden DBE, "UK corporate governance after Enron" (2003) 3 *Journal of Corporate Law Studies* 269, at 279, where the compliance figure in 2003 is estimated as being around 90%.

49 See Combined Code, n. 4 above.

50 Ibid., p. 7 (my emphasis added).

51 Ibid.

52 Ibid.

capabilities were thrust into the public and political eyes.[53] Nevertheless, the specific degree of weight that should be afforded to the DoLR doctrine, relative to other Code norms and also to any extraordinary firm-specific circumstances, has become a topical issue of debate following the recent investor furore surrounding the promotion of M&S's CEO Sir Stuart Rose to the dual position of the company's executive chair.

M&S first publicly announced its decision in this regard on Monday 10 March 2008, after which the company's then-chair, Lord Burns, compiled a five-page letter to the company's major institutional shareholders outlining the board's reasons for adopting this unusual governance policy.[54] In his letter, Lord Burns explained that, since no single member of M&S's current board had been with the company prior to the high profile boardroom "clear out" in 2004, both the nomination committee and general board were of the opinion that there was no viable internal candidate currently equipped to take over the CEO position, and that it was therefore "felt important to be able to create an environment in which internal candidates could develop over a defined period of time".[55] Lord Burns further explained that, while the possibility of the company recruiting an external candidate for the office had also been considered, the board's conclusion was that during the present tumultuous trading environment this "was likely to be a damaging and unwelcome distraction at precisely the time that the business needed clear leadership to sustain its recovery and transformation".[56]

At the same time, aware that this course of action entailed deviation from Principle A.2 of the Combined Code, Lord Burns set out a list of "balancing controls" which he claimed would "mitigate the governance concerns that [a joint chair–CEO] structure might otherwise engender",[57] including (inter alia): (a) promoting the company's current senior NED, Sir David Michels, to the position of non-executive deputy chair, in which capacity "[h]e will chair the Nomination Committee, provide leadership for the Independent Directors, be responsible for monitoring Board Effectiveness and lead on Corporate Governance issues";[58] (b) creating a new senior executive position of group finance and operations director (to be filled by current executive director Ian Dyson) in order to reallocate a significant number of the executive chair's previous day-to-day CEO responsibilities, thereby enabling Sir Stuart Rose "to concentrate on the strategic growth areas of the business";[59] (c) rendering Sir Stuart Rose's three-year tenure as executive chair conditional upon annual shareholder re-appointment by way of a resolution to be passed at each subsequent AGM of the company;[60] and (d) ensuring that the proposed new arrangement is only a "transitional governance structure leading to appointment of a new Chairman and Chief Executive by Summer 2011".[61]

53 On this generally, see J Armour and J A McCahery, "Introduction", in Armour and McCahery, *After Enron*, n. 36 above, p. 1; W Bratton, "Enron and the dark side of shareholder value" (2002) 76 *Tulane Law Review* 1275; S Deakin and S Konzelmann, "Learning from Enron" (2004) 12 *Corporate Governance* 134; M Aglietta and A Rebérioux, *Corporate Governance Adrift: A critique of shareholder value* (Cheltenham: Edward Elgar 2005), ch. 8.

54 See Lord Burns, "Letter to shareholders re management changes", 3 April 2008, available on *The Guardian* website at http://image.guardian.co.uk/sys-files/business/documents/2008/04/03/lettertoshareholders.pdf.

55 Ibid., p. 3.

56 Ibid., p. 2.

57 Ibid., p. 4.

58 Ibid.

59 Ibid.

60 Ibid.

61 Ibid., p. 5.

Although a small number of M&S's institutional shareholders such as Invesco Perpetual and Standard Life publicly supported the board's unorthodox policy in this regard,[62] the overall air of investor opinion in the press was one of hostility.[63] In some instances this negative reaction was understandable, such as where Legal & General claimed to have been given only one hour's notice of the company's decision prior to its official public announcement, thus rendering impossible any effective process of consultation between the two parties prior to finalisation of the company's policy in this regard.[64] This is despite Combined Code Provision A.2 clearly requiring that the board *consult* (and not just inform) the company's major shareholders in advance of any definite decision to amalgamate the CEO and chair positions.[65] In other instances, however, the basis for investors' antagonism towards M&S's board was not so clearly comprehensible, and arguably suggested a fundamental misunderstanding from some quarters as to the precise normative status of the Code. For example, Peter Chambers, chief executive of Legal & General Investment Management, was recorded in *The Times* newspaper as saying:

> We believe we have a moral responsibility to uphold corporate ethics in the UK and believe bellwether companies share this responsibility. We don't believe M&S should be explaining why they are not complying. They should be complying.[66]

In a similar tone, Schroder's head of UK equities Richard Buxton reportedly accused the company of setting "an appalling example"[67] on corporate governance by promoting its CEO in this way, despite M&S's board having undertaken to provide a detailed written account to shareholders of its reasons for adopting this unorthodox policy.

"Clash" of Code Principles

While the basic proprietary entitlement of shareholders to form their own conclusions in respect of controversial governance matters should ultimately be respected, there is the risk that an overly conservative approach by investors towards policing compliance with the Code might pressurise boards to forego potentially value-adding "alternative" governance structures in favour of an inappropriate one-size-fits-all model.[68] Indeed, the Preface to the 2006 edition of the Combined Code[69] emphasises that, "[w]hilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the

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62 Invesco Perpetual's Head of Equities Neil Woodford claimed that "[i]t is entirely appropriate for the M&S board to have taken the decision they have reached with regard to Stuart Rose", in that "[i]t is especially important to create an executive structure that maintains Stuart's leadership of the business but that also enables him to bring on successor talent such that at the appropriate time he can step down". See M Donati, "M&S makes concession to appease shareholders", *Drapers Record*, 3 April 2008.

63 See Z Wood, "This isn't just any shareholder revolt . . .", *The Observer*, 6 April 2008.

64 S Hawkes and P Hosking, "L&G given one hour's notice of M&S decision to promote Rose", *The Times*, 12 March 2008.

65 Although the board afterwards justified this deviation from proper Code procedure in its annual Corporate Governance Statement for 2008 on grounds of the risk of potential press leaks resulting from such private consultations. The statement is available to consult on the company's website: www.marksandspencer.com.

66 D Walsh, "Investor outcry smothers hope of pay rise for Rose in dual role at M&S", *The Times*, 31 March 2008.

67 S Hawkes, "M&S says it had to raise Rose to executive chairman role", *The Times*, 4 April 2008.

68 On this general problem, see the responses to the FRC's recent review of the Combined Code's operation, as published in *2007 Review of the Combined Code: Summary of responses to consultation* (London: FRC November 2007), esp at paras 17–24. For the initial review agenda, see FRC, *Review of the Impact of the Combined Code* (London: FRC April 2007). Both at www.frc.co.uk/corporate/combinedcode.cfm.

69 This was the relevant edition of the Code in operation for most of the period of the M&S affair.

Code should not automatically be treated as breaches".[70] Rather, "institutional shareholders should carefully consider explanations given for departure from the Code and make reasoned judgements in each case".[71]

Even on the assumption, though, that shareholders are prepared to evaluate carefully a company's explanation for deviating from any Code provision and make reasoned judgments thereon,[72] there remains doubt as to the precise "high-level" considerations that should guide shareholders' deliberations in this regard. In the M&S case, for instance, Lord Burns amplified in his letter to shareholders that "the Board has taken what it believes is the best decision for shareholders, cogniscent of *its prime objective to ensure the Company's ongoing commercial success*."[73] This point is expanded on by M&S's board in its annual Corporate Governance Statement for 2008, where it explains in further detail how the new management structure will be conducive to stable and effective leadership for the ultimate benefit of the company and its shareholders.[74] The difficulty, though, is that, while the board is correct to recognise that promoting the long-term success of the company for the benefit of its shareholders is the board members' over-riding positive legal duty as directors,[75] the criterion of "corporate success" is not expressly stated at any point in the relevant Code Principle (A.2) pertaining to the issue of division of leadership responsibilities.

The only reference in the Code to the "corporate success" criterion appears in Principle A.1, which deals with the separate (albeit not unrelated) issue of board leadership. Main Principle A.1 states that "[e]very company should be headed by an effective board, which is collectively responsible for the success of the company".[76] Supporting Principle A.1 meanwhile expands on this by explaining that the board's overall role "is to provide entrepreneurial leadership of the company".[77] In explaining how this Principle had been applied in the context of their proposed restructuring plan, M&S's board stated that "[t]he new structure will ensure continuity of leadership, strengthen the Board and streamline the organisation", thereby "focus[ing] everyone on business performance during a period of significant trading uncertainty" while also "address[ing] investor concerns over succession".[78]

In contrast to Principle A.1's dynamic "leadership" doctrine and its annex to the projected commercial benefit of the company, however, Principle A.2 is markedly more "static" in form. Under Main Principle A.2, the division of leadership responsibilities at the top of the company arguably appears to represent a worthy goal of the Code in its own right, regardless of any wider strategic factors that may justify temporarily sacrificing separate board vis-à-vis business leadership in favour of achieving concentrated entrepreneurial direction of the company. In other words, rather than being viewed merely as a procedural means towards the ultimate substantive end of ensuring effective board leadership and resultant corporate success, the DoLR doctrine is potentially construable as an independent policy goal of British corporate governance *in itself*. On this basis, investors might legitimately query the extent to which M&S board's reasoned reference to "the Company's ongoing

70 FRC, *The Combined Code on Corporate Governance* (London: FRC June 2006), p. 2, available at www.frc.org.uk/corporate/combinedcode.cfm.

71 FRC, Combined Code, n. 70 above. This important statement is almost wholly reproduced in the revised Preface to the current 2008 edition of the Code, on which see nn. 94–6 below and accompanying text.

72 This assumption is, admittedly, somewhat tenuous: see FRC, *2007 Review*, n. 68.

73 Burns, "Letter", n. 54 above, p. 5 (my emphasis added).

74 M&S, Statement, n. 65 above.

75 By virtue of the directors' statutory duty of loyalty under s. 172 of the Companies Act 2006.

76 Combined Code, n. 4 above, p. 5.

77 Ibid.

78 M&S Statement, n. 65 above.

commercial success"[79] provided a truly valid justification for eliding separation of its chair and CEO functions, as according to the literal wording of the Code this ultimately entailed the board deploying one independent policy goal of the Code (effective leadership) to defend its non-fulfilment of another, apparently *equally high-ranking* goal (DoLR).

In justifying non-compliance with Code Provision A.2.1 in its annual Corporate Governance Statement, M&S's board cited the proposed "back-up" arrangement that had previously been detailed in Lord Burns' letter,[80] most notably including the creation of a new non-executive deputy chairship position to provide an effective check on the executive chair's power.[81] However, investors might reasonably question whether even in this respect the board referenced a criterion of relevance to Principle A.2's DoLR doctrine, since strictly speaking the deputy chair constitutes a senior independent director and therefore falls to be covered under the rubric of the separate Code Principle A.3 on the issue of board balance and independence. Main Principle A.3 provides that "[t]he board should include a balance of executive and non-executive directors (and in particular non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking".[82] Code Provision A.3.3 further recommends that the board should nominate one of the independent NEDs to act as a senior independent director, echoing the previous recommendations in this regard which followed the Cadbury and Hampel Reports.[83]

In view of the fact that M&S's creation of the Deputy Chairship position was achieved by promoting the company's existing senior independent director (Sir David Michels) to this functionally more senior position, while retaining (and, moreover, strengthening) his status as the premier non-executive member of the board (outside the chair), it may be argued that for the purposes of the Code he should continue to be formally treated as the company's de facto senior NED. According to this logic, the strengthening of Sir David Michels' boardroom influence under the reorganisation should be treated primarily as a factor relevant to the achievement of boardroom balance and independence for the purposes of Principle A.3. On the other hand, this criterion is arguably *of no direct relevance* to the attainment of an effective division of leadership responsibilities for the purposes of Principle A.2, given that the role of deputy chair is not a leadership position in the strict sense of the term.

Therefore, even though the issue of board balance and independence is by no means far removed from that of DoLR, there is once again an apparent collision of equal-ranking Code Principles. In this instance, the achievement of a balance of executive and non-executive influence on the board (as required by Principle A.3) is effectively cited as a "defence" to the "charge" of failing to comply with Principle A.2's DoLR norm. Further, since M&S's board felt the need to explain Sir David Michels' appointment at three separate points in the company's annual Corporate Governance Statement[84] in view of the perceived relevance of this criterion to each of the Code's first three Principles (A.1–A.3), there resulted an inevitable degree of repetition of material which arguably diminished the intended narrative flow of the document.

79 See M&S Statement, n. 65 above.

80 See Burns, "Letter", n. 54 above,.

81 On this, see ibid. and text accompanying n. 58 above.

82 Combined Code, n. 4 above, p. 7.

83 On which, see, respectively, Cadbury Report, n. 5 above, and text accompanying n. 42 above; and Hampel Report, n. 16 above, and text accompanying n. 45 above.

84 See M&S, Statement, n. 65 above.

Potentially differing conceptions of an efficient board structure

Of course, the fact that non-compliance with any provision or even Main Principle of the Code (including the DoLR doctrine) is formally permissible when accompanied by a satisfactory explanation from the board theoretically means that, regardless of the precise wording or relative grading of different Code Principles, the criterion of corporate success (at least where effectively articulated by the board) will always "trump" any other considerations expressed within the Code. However, translating this theoretical position into the actual practice of compliance monitoring by shareholders is problematic on account of the absence of any common agreement amongst the investment community as to what actually signifies "corporate success".

On one view, the success of a company may be equated with its entrepreneurial dynamism and resultant capacity for product market innovation.[85] Such qualities would appear to be consistent with a board structure that facilitates concentrated strategic leadership unencumbered by onerous extraneous constraints such as a divided leadership structure.[86] It is also likely, however, that investors will perceive a company's propensity for success as being reflected in the extent to which its senior managers are willing to "bond" the stock market's expectations by voluntarily submitting to an onerous board monitoring regime. In other words a company's managers may choose to "tie their own hands", metaphorically, in order to project a credible signal to investors that the latter's wealth will not be expropriated or otherwise diminished through mismanagement of the business.[87] Such a governance strategy may prove to be particularly valuable in companies where there exists either a significant informational deficit or serious absence of trust between managerial "insiders" and stock market "outsiders",[88] with the likely effect that investors will be unable or unwilling to accept with confidence the specific strategic reasons proffered by managers in support of a non-compliance decision as a credible justification for deviation from the Code.[89]

Adopting this latter course of logic, the criterion of DoLRs becomes of paramount importance not only as a factor that is generally conducive to a successful corporate governance system, but also as an *a priori* determinant of managerial (and consequent corporate) efficiency *in its own right*. Therefore, insofar as Principle A.2 presents the DoLR doctrine as being an independent goal of the Code which, moreover, is on an apparent par with the Principle A.1 goal of effective leadership, one could reasonably be led to the conclusion that both Principles represent alternative (and potentially conflicting) conceptions of what constitutes an efficient board governance structure. It follows from this that to the extent a relatively uninformed or untrusting investor regards managerial accountability as being a more credible determinant of likely corporate success than entrepreneurial flexibility, they are entitled to regard Principle A.2 in effect as a *mandatory* managerial constraint regardless of any reasons that a board may offer in an attempt to justify temporary deviation from this norm.

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85 See e.g. J A Schumpeter, *Capitalism, Socialism and Democracy* (London: Allen & Unwin 1976), ch. 7.

86 On this, see n. 38 above and accompanying text.

87 On this concept generally, see n. 8 above and accompanying text.

88 On the general economic value of trust as a means of encouraging "one-shot" interactions amongst strangers within large organisations such as public companies, see R La Porta, F Lopes-De-Silanes, A Shleifer and R Vishny, "Trust in large organizations" (1997) 97 *American Economic Review Papers and Proceedings* 333; F Fukuyama, *Trust* (New York: Free Press, 1995).

89 The original exponents of the idea of the board of directors as a managerial "bonding" device were the financial economists Michael Jensen and Bill Meckling, who first advanced the notion in their pathbreaking 1976 article "Theory of the firm", n. 36 above.

Re-affirming the practical relevance of "comply or explain"

The need for a "Macro-Principle" in the Combined Code

Although the recent approval by M&S's shareholders of its controversial board reorganisation plans[90] at the company's 2008 AGM has put an (at least temporary) end to the recent controversy surrounding the company's governance structure,[91] this episode is by no means of academic interest only. On the contrary, the M&S debacle highlights continuing problems with the drafting of the Combined Code and, in particular, the Code's arguably excessive level of prescription in certain key respects.[92] As the M&S case vividly illustrates, this is a source of uncertainty not only for boards themselves in compiling effective and relevant explanations for non-compliance with any Code provision(s), but also for investors and their corporate governance advisors. The latter group is increasingly faced with the need to make difficult and uncertain judgments on the basis of necessarily limited information, equipped with a collection of confusing and, at times, contradictory yardsticks in the Code as to what constitutes a good governance structure.

To this end, the FRC has very recently implemented a moderate change to the Combined Code as an outcome of its 2007 review of the Code's operation.[93] The latest 2008 edition of the Code accordingly contains a revised and more detailed Preamble, which begins by amplifying the following two key considerations:

> (i) Good corporate governance should contribute to better company performance by helping a board discharge its duties in the best interests of shareholders
>
> (ii) Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term[94]

The new Preamble further makes clear that "[t]he Code is not a rigid set of rules", but rather is "a guide to the components of good board practice distilled from consultation and widespread experience over many years".[95] It is therefore "recognised that non-compliance may be justified in particular circumstances *if good governance can be achieved by other means*".[96] This addition to the Code was prompted by concerns voiced as to the general level of detail in the Code today, and the consequent bureaucratic burden that the conformance process has come to entail for investors and boards alike.[97] In particular, the

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90 On these plans, see nn. 54–61 above and accompanying text.

91 On the other hand, the fact that 22% of M&S's voting shareholder base either abstained from voting on, or else actively opposed, the resolution to appoint Sir Stuart Rose to the office of executive chair demonstrates the continuing high level of investor hostility in relation to this issue. See T Braithwaite, E Rigby and K Burgess, "M&S shareholders give Sir Stuart dressing down in promotion vote", *Financial Times*, 10 July 2008. Indeed, in January 2009, Sir Stuart Rose was again asked to justify publicly his dual executive chair position in light of the company's announcement of twenty-seven planned store closures following disappointing quarterly sales figures. In response, Sir Stuart reportedly advanced the colourful defence that "[i]f this was an aeroplane flying through a storm, I don't think the best thing to do is shoot the pilot". See M Leroux, "Rose spurns a pay rise as M&S cuts costs by £200m", *The Times*, 8 January 2009.

92 On this, see nn. 72–84 above and accompanying text.

93 For the review itself and subsequent responses to the FRC consultation, see FRC, *Summary of Responses*, n. 68 above.

94 Preamble, Combined Code, n. 4 above, para. 1.

95 Ibid., para. 2.

96 Ibid. (my emphasis added).

97 As the Institute of Directors opined in its response to the review, for instance: "[m]any directors . . . consider that a disproportionate amount of their effort is directed towards compliance and conformance, rather than the strategic direction of the company". See FRC, *Summary of Responses*, n. 68 above, para. 5.

FRC acknowledged in its review a number of requests from respondents for it to "emphasise that the primary objective of the Code is to support the board in providing entrepreneurial leadership of the company".[98]

The above statements together represent a constructive addition to the Code, and should go at least some way towards improving the quality and commonality of dialogue between boards and investors in cases of strategic non-compliance. There is, nevertheless, some cause for scepticism as to how effective this change will prove on its own, absent any more thoroughgoing alteration of the relative weighting of the Code's intrinsic Principles. Indeed, it is notably also stated in the revised Preamble to the 2008 edition of the Code that, where a board chooses not to comply with any of the Code's provisions, it "should aim to illustrate how [the company's] actual practices are consistent with the principle to which the particular provision relates *and* contribute to good governance".[99] The use of the word "and" (as opposed to "or") here is significant in that it suggests boards should not attempt to justify an alternative governance practice (for example, a combined executive chair appointment) by reference to any determinant of "good governance" *other than* the relevant Code Principle itself (for example, the DoLR doctrine in Principle A.2).[100] If followed literally by boards and their governance advisors, this particular statement would therefore appear to contradict (and hence undermine) the FRC's expressed objective in revising the Preamble to the Code, which is to encourage a less rigid and more dynamic approach by boards and investors towards their respective tasks of compiling and evaluating companies' annual governance statements.

Of course, it remains open to boards to attempt to justify non-compliance with any Code provision via reasoned reference to a term of the Preface itself. For example, M&S's temporary executive/deputy-chair leadership structure is arguably a means of securing "efficient, effective and entrepreneurial management",[101] and this *in itself* is therefore a potentially acceptable justification for adopting such an unorthodox arrangement. However, an explanation phrased in these terms, regardless of its genuineness or quality, will be a highly risky strategy for boards given the absence of any express guidance in the Code as to the relative weighting to be afforded to the Preface vis-à-vis the Code's intrinsic Principles and Provisions.

It is therefore submitted that there is a need for the FRC to give serious thought to the feasibility of implementing a more fundamental alteration of the Combined Code along the above lines during its next planned Review process in 2010. In particular, the FRC should consider the feasibility of establishing a unifying "Macro-Principle" of the Code, which might provide an objective basis upon which both boards and investors can evaluate and "grade" conflicting Code norms in the event that a proposed governance policy appears to put one or more Main Principles into conflict with one another. This could be achieved by elevating the normative status in the Code of Principle A.1 (board leadership) relative to Principles A.2 and A.3 (DoLR and board independence and balance). By reforming the lexical order of these three key Principles in this way, the FRC will vest boards with greater freedom to produce a comprehensive economic case for temporarily deviating from a standard (divided) leadership structure.

Rather than merely adding a further unwanted layer of prescription to the Code, such a reform will in fact provide a much-needed common criterion around which to structure

98 FRC, *Summary of Responses*, n. 68 above, para. 7.

99 Combined Code, n. 4 above, para. 5 (my emphasis added).

100 On this, see nn. 31–52 above and accompanying text.

101 Preamble, Combined Code, n. 4 above, para. 1., and text accompanying n. 94 above.

productive dialogue between boards and investors as to innovative strategies for application of the Code's various Principles and Provisions. In this way, it promises to reduce the risk of costly misunderstandings occurring between both sides, which often have the effect of encouraging "blanket" compliance by boards with the Code's provisions aimed at pre-empting potential public dispute and/or shareholder reprisal.[102]

Simplification of corporate governance statements

In its recent Review, the FRC acknowledged further comments from some respondents as to the arguably excessive reporting demands entailed by the dual "appliance" and "compliance" dimensions of the corporate governance statement. In particular, submissions were received to the effect that:

> the requirement in the Listing Rules for boards to state how they have applied the Code's principles (as well as how they have complied with or explained its provisions) was adding unnecessarily to the "boilerplate" disclosures because it "is often interpreted as a requirement to explain how all 60+ elements of the Main and Supporting principles are applied".[103]

It was observed that, partly as a result of this, many companies were copying the same material in their corporate governance statements on a year-on-year basis with little regard to whether the discussion therein referenced factors of relevance to the company's current situation.[104]

Insofar as the corporate governance reporting obligation stems not from any provision of the Code itself but rather from the Listing Rules of the LSE, it falls outside of the FRC's jurisdiction and instead within the remit of the Financial Services Authority (FSA) as the UK's Listing Authority. The FSA has, however, recently taken it upon itself to tackle this issue within the purview of its implementation of EU Directive 2006/46/EC on company reporting. In essence, the directive inserts a new Art. 46a into the existing EU Fourth Company Law Directive, requiring all companies whose securities are admitted to trading on a regulated market in the EU to (inter alia) publish an annual corporate governance statement similar in key respects to that which listed UK companies are currently expected to produce by virtue of Listing Rule 9.8.6 (5)–(6).[105]

Since, in relation to listed UK companies at least, the new European rule effectively gold-plates the existing domestic requirement for a company to publish an explanatory statement in respect of its compliance (or otherwise) with the Combined Code, the FSA has provided that a British company which complies with its current listing obligation in this

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102 Indeed, one notable factor conducive to a perfunctory box-ticking approach by investors and companies towards Code compliance is the potential for differing estimations by these two groups of the likely costs of compliance with any particular Code provision. As MacNeil and Li explain, "[a] high cost of compliance may well create an expectation within a company that investors would regard non-compliance as justified, but there remains the risk that the company's assessment of this issue would not be the same as investors, not least because assessment of the cost of compliance is largely subjective". See MacNeil and Li, "Comply or explain", n. 48 above, p. 487.

103 FRC, *Summary of Responses*, n. 68 above, para. 47, citing a quote from the corporate governance lobby group Quoted Companies Alliance.

104 In response to the FRC's recent review of the Combined Code's impact, one company chair admitted that "the majority of the information contained in the corporate governance section is copied from year to year or plagiarised from somewhere else. There is neither time nor the appetite for discussion or debate about the quality of the content." See FRC, *Summary of Responses*, n. 68 above, para. 43, citing a quote from Ian Paterson.

105 On this, see DTI (now Department for Business, Enterprise & Regulatory Reform (BERR)), *Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company: A consultative document* (London: DTI March 2005), pp. 21–3.

regard will be treated as *immediately satisfying* the corresponding EU requirement.[106] But the EU-wide "comply or explain" principle is on a procedural level not as demanding as its UK counterpart insofar as the European rule requires only that a company discloses: (a) the particular corporate governance code to which it is subject; (b) the extent to which it complies with the provisions of that code; and (c) any reasons for non-compliance with those provisions. Unlike the UK requirement, though, the EU rule does not demand the publication of a further narrative "appliance" statement detailing the company's policy in relation to application of the relevant code's provisions as a whole.

Accordingly the FSA, in formulating its policy for implementation of the directive's requirement in respect of the corporate governance statement, expressly considered removing the much-criticised "appliance" aspect of the domestic governance disclosure rule. This was for the dual purpose of bringing the UK regime into line with the basic standard applicable across the EC as a whole, while at the same time responding to the concerns raised by respondents to the recent FRC review about the tendency for boiler-plating of companies' appliance statements.[107]

The FSA's final view on the matter was that it should retain the dual appliance and compliance components to the disclosure obligation, but that Listing Rule 9.8.6(5) should be slightly altered so as to provide expressly that the "appliance" aspect of the statement need only reference how the company has applied the *Main Principles* set out in s. 1 of the Combined Code, as opposed to the provisions of this part in general, as was the previously understood position under the rule.[108] Listing Rule 9.8.6(5) has since been altered accordingly.[109]

The FSA's simplification of the corporate governance disclosure requirement will not resolve the difficulties faced by investors in evaluating the relative importance of seemingly conflicting Code Principles. However, it will give boards greater freedom to explain how their governance arrangements achieve the general outcomes expected by the Principles, unencumbered (at least in the first part of the statement) by the need to link the company's policies in respect of each Principle to the more detailed Code Provisions underlying that general norm. As such, it should be welcomed as a constructive, albeit incomplete, move in the direction of enhancing the characteristic flexibility of the Code's application, which should in turn help to mitigate the effect of the increased prescriptiveness of its key governance Principles.[110]

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106 This is by virtue of the new Rule 7.2.4G of the FSA's Disclosure and Transparency Rules (DTR), which expressly provides that "[a] listed company which complies with LR 9.8.6R(6) (the comply or explain rule in relation to the Combined Code) will satisfy the requirements of DTR 7.2.2R and 7.2.3R [i.e. the obligation to include a comply or explain statement in its annual corporate governance statement as required by the EU Fourth Company Law Directive]".

107 See BERR, *Implementation of Directive 2006/46/EC on Company Reporting – Amending Accounting Directives: Government response* (London: BERR July 2007), para. 3.9.

108 See FSA, *Implementation of the 8th Company Law Directive: Feedback on CPO7/24 and final rules* (London: FSA June 2008), paras 2.12–2.13.

109 Listing Rule 9.8.6(5) now states that, "[i]n the case of a listed company incorporated in the United Kingdom . . . its annual financial report [must contain] a statement of how the listed company has applied the *Main Principles* set out in section 1 of the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied" (my emphasis added). In the previous (pre-2008) version of the rule, the highlighted term "Main Principles" read merely "Principles", which was deemed to give an insufficiently clear indication of in relation to which specific level(s) of the Code's norms a company's board was required to explain its appliance strategy.

110 For an example of this last trend, see nn. 49–52 above and accompanying text.

Conclusion

It is hoped that this article will contribute towards the continuing policy debate in relation to the future development of the UK's corporate governance regulatory regime and, in particular, to the FRC's next-planned review of the Combined Code in 2010. In any event, it should be emphasised that, however regulators choose to proceed in this area in future, they must resist the temptation to respond in a knee-jerk manner to the recent turmoil in international financial markets by proposing either increased prescriptiveness of the Code's substantive provisions, or else further formalisation of the method for its enforcement.[111] As the experience of the controversial Sarbanes-Oxley legislation in the United States has illustrated, there are no guarantees that such a step will be conducive in the long run either to a more attractive investment environment, or to more accountable or responsible corporate management.[112]

In the context of these concerns, it is therefore reassuring to note a comment by the FRC's chief executive Paul Boyle that, in the council's belief, "the recent difficulties in the financial sector do not require a general tightening of governance standards across the UK corporate sector".[113] It is submitted that, for the reasons set out above, such a cautious approach towards reform of the current regulatory environment should be strongly encouraged. Moreover, any future suggestions for reform of the Code should be focused towards the goal of enhancing, rather than encumbering, the capacity of the Code to engender effective, performance-enhancing board structures on an individual company level. This is because a truly dynamic and company-specific system of compliance monitoring, far from undermining managerial accountability, will on the contrary provide boards with a greater incentive to take their company's annual corporate governance statement seriously, instead of viewing it as a mere bureaucratic inconvenience bearing little relevance to the company's "real" business affairs.

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111 Ferran argues that "[a] system of corporate regulation tailored to the needs of modern business should, ideally, combine elements of both [command and control, and responsive or reflexive regulation], *but with a preference for responsive regulation* wherever there exist effective incentives to generate a culture of compliance amongst market participants". Ferran, "Corporate law", n. 19 above, p. 385 (my emphasis added).

112 On this, see Aglietta and Rebérioux, *Corporate Governance Adrift*, n. 53 above, pp. 244–7; L Ribstein, "International implications of Sarbanes-Oxley: raising the rent on US law" (2003) 3 *Journal of Corporate Law Studies* 299, at 300; A Barden, "US corporate law reform post-Enron: a significant imposition on private ordering of corporate governance?" (2005) 5 *Journal of Corporate Law Studies* 167, at 167–8; E Uhlfelder, "US delistings changing the landscape for investors", *Financial Times*, 23 July 2007; D Berman, "Post-Enron crackdown comes up woefully short", *Wall Street Journal*, 28 October 2008.

113 See P Boyle (chief executive, FRC), "Address to Pan Accountancy Profession lunch", Mansion House, London, 23 October 2008, p. 4, at www.frc.org.uk/press/pub1750.html.

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Governance reform pressures and processes in the NHS in Scotland

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Introduction

In the private sector the collapse of Enron has been seen as putting corporate governance processes under significant pressure, so much so that "post-Enron" is a well-recognised and frequently used phrase. This article moves outside the private sector, but remains focused on organisations with large budgets and the potential for large corporate governance problems. It examines corporate governance developments, mostly post-Enron, in the NHS in Scotland. NHS boards in Scotland are public bodies operating in a country where health has been a devolved matter since 1998. This article aims to reveal the corporate governance pressures that affect NHS board governance in Scotland, including those that can be traced back to Enron. There are various sources for the pressures that might be expected to impact on the corporate governance of the NHS in Scotland including: UK corporate governance pronouncements; UK public sector pronouncements; more generally the world of corporate governance pre- and post-Enron; pressures particular to devolved Scotland;[2] and changes to UK level regulation of the healthcare professions. The processes that determine the shape of corporate governance in the NHS are, generally, much more "top down" and directed than the private sector equivalent in the UK. Pre-devolution, ministerial and parliamentary direction came from London (Westminster). After devolution, statutes of the Scottish Parliament and HDLs[3] issued by the relevant minister became the most immediate source of NHS governance rules.

Following this introduction the article has a short chronology giving an outline of relevant events pre- and post-Enron. It then explores the influence of private sector corporate governance developments post-Enron. The influence of the approach to internal control taken by the Turnbull Guidance is considered separately as this spans the pre- and post-Enron periods but is an important corporate governance development in the private sector that spills over to the NHS. Finally, the article explains and assesses some governance

1 The author acknowledges the assistance of AHRC Network award AH/E510620/1: see www.dundee.ac.uk/artsoc/rig/ and the opportunity to present and discuss an earlier version at the ESRC-funded colloquium "The Globalization of Corporate Governance? Reform pressures and processes in an era of financial crises", 17–18 September 2008, Queen's University Belfast under the aegis of the "Regulatory Regime Change in Financial Markets: the Case of Sarbanes-Oxley" project.

2 Currently under the SNP.

3 Health Department Letters.

developments that are happening in the NHS in Scotland that are being driven by the "public involvement" agenda of the current Scottish Government, in particular, the introduction of board members directly elected to health boards.

Chronology

This chronology picks out a few key developments concerning the NHS, the public sector and Scotland and positions them against corporate governance landmarks both before and after Enron. The NHS has gone through many reforms over its sixty-year history. In 1990, the National Health Service and Community Care Act 1990 brought the concept of the "internal market" to the NHS and with it ideas about the operation of markets and financial performance that had previously been unknown. The corporate governance ideas of the Cadbury Code, published in 1992, were transferred to the NHS almost immediately with the introduction in 1994 of the first NHS Codes of Conduct and Accountability.[4] Also around this time the Nolan Report, published in 1995, included seven Principles of Public Life which remain relevant benchmarks of behaviour.[5]

Under the Scotland Act 1998, some of Westminster's powers were devolved to a Scottish Parliament. One devolved area is health and, almost immediately, the NHS in Scotland was taken back into the public sector and put under direct ministerial control. The current system of governance for the NHS in Scotland was set out in the 2001 White Paper *Rebuilding our National Health Service*. This was followed by the Health Boards (Membership and Procedure) (Scotland) Regulations 2001 which constituted many of the NHS organisations in Scotland as either territorial health boards or special health boards. The special health boards cover the whole of Scotland, for example, the Scottish Ambulance Service. All these boards are public bodies reporting directly to the relevant minister. The move away from the market and back towards direct ministerial control came immediately before the Enron collapse; Enron entered "chapter 11" in December 2001.

In the post-Enron period governance of the NHS in Scotland could continue to draw inspiration from private sector developments; or from specifically public sector governance initiatives; or from both. In the private sector, the main developments that followed Enron are found in the Higgs and Smith Reports. The other major development that straddles the pre- and post-Enron periods is the implementation of the internal control provision of the Cadbury Code following the publication in 1999 of the Turnbull Guidance. In 2004, the NHS in Scotland was finally constituted as simply health boards and special health boards when the remaining NHS trusts were dissolved under the National Health Service Reform (Scotland) Act 2004. In the public sector more generally, 2004 also saw the publication of *The Good Governance Standard for Public Services*.[6]

The influence of the private sector post-Enron

The contents and impact of the Higgs Report are well known to UK corporate governance scholars. Commissioned by the Secretary of State, Patricia Hewitt, and the Chancellor, Gordon Brown, Higgs produced a consultation paper in June 2002, responses were accepted until September 2002, and the final report was issued in January 2003. Both the consultation paper and the final report were entitled *Review of the Role and Effectiveness of Non-executive Directors*. The report's influence on the public sector can be seen in the 2004 standard already mentioned. For public bodies in Scotland, it can also be seen in the training

4 A Belcher, "Codes of conduct and accountability for NHS Boards" (1995) (summer) *Public Law* 288–97.

5 Nolan Committee, *First Report on Standards in Public Life* (London: HMSO, 1995).

6 Independent Commission for Good Governance in Public Services, *The Good Governance Standard for Public Services* (London: OPM 2004).

material issued to board members: *On Board: A guide for board members of public bodies in Scotland* was published in 2006.[7] The role of the board member focuses on four key areas: strategy, performance, risk and behaviour.[8] It also states that the effective non-executive board member:

- upholds the highest ethical standards of integrity and probity (and complies with the public body's Code of Conduct for Board Members);
- supports executives in their leadership of the business while monitoring performance;
- questions intelligently, debates constructively, challenges rigorously and debates dispassionately;
- listens sensitively to the views of others, inside and outside the board;
- gains the trust and respect of other board members;
- and maintains a focus on strategy and performance and is not distracted by detail.[9]

The NHS in Scotland could only understand and implement this sort of guidance due to the earlier reforms required by the Health Boards (Membership and Procedure) (Scotland) Regulations 2001 which were themselves accompanied by guidance issued by the Scottish Executive Health Department in May 2001.[10] Under this guidance the board (of directors) of a health board (organisation) is said to be a "Board of Governance" and is "not a management Board" but "will have collective responsibility for the performance of the local NHS". Boards are held to account for their performance through the Local Delivery Plan; a set of targets agreed with, or sometimes dictated by, the Scottish Government Health Department. There is also an annual review process. This is probably the closest thing there is to an AGM. The public can be present and can ask questions if the board is notified in advance. It should be noted, however, that the chair of the audit committee is not required to be present at the annual review and often is not. This is one Smith Report requirement that has not been followed through by the NHS in Scotland.

The board of directors of an NHS territorial board currently comprises executive directors appointed by the minister, an employee board member, non-executive directors appointed through the public appointments system and, again, formally appointed by the minister, and members nominated from the local councils for the territory it covers. Boards of directors of special health boards do not have councillor members, but are otherwise the same. Both types broadly match the private sector form of a unitary board comprising executives and non-executives. However, board meetings[11] are held in public and this sometimes means a press presence. Another way in which the NHS governance structure differs from the private sector is that the board is collectively responsible, but there is also a named "accountable officer", usually the chief executive, who is personally responsible.

7 Scottish Executive, *On Board: A guide for board members of public bodies in Scotland* (Edinburgh: Scottish Executive 2006).

8 These roles map onto the "strategy, performance, risk and people" roles of *Good Practice Suggestions from the Higgs Report* (London: FRC June 2006).

9 Scottish Executive, *On Board*, n. 7 above, para. 3.7.

10 "Rebuilding our National Health Service: guidance for NHS chairs and chief executives for implementing 'Our National Health': a plan for action, a plan for change" (Edinburgh: Scottish Executive Health Department May 2001). Under the current administration, the Scottish Executive Health Department has been renamed the Scottish Government and the Health Department (SGHD) and is now part of the Ministry of Health and Wellbeing.

11 But not board workshops or subcommittee meetings.

The annual report for NHS Education for Scotland (NES) has statements by the board as a whole acknowledging their collective responsibility and a statement by the accountable officer acknowledging their personal responsibility.[12] The accountable officer appears to be a public sector concept that has been retained despite its incompatibility with the unitary board governance structure imported from the private sector.

A second private sector response to Enron was the Smith Report giving "Audit committees Combined Code guidance".[13] Again this followed on from government action in establishing the Co-ordinating Group on Auditing and Accounting Issues. Key Smith Report changes to the existing Corporate Governance Code were; that the audit committee is to comprise three independent non-executive directors and at least one is to have recent relevant financial experience;[14] that the audit committee should have written terms of reference;[15] that the audit committee should have a separate section in the annual report;[16] and that the chair of the audit committee should be available to answer questions at the AGM.[17] The requirements for recent relevant financial experience and written terms of reference have been taken up by the NHS. The availability of the audit committee chair has already been discussed, but in the NHS in Scotland there is no exact equivalent of the AGM. The recommendation for a separate section in the annual report for audit committee has also not been taken up in the NHS in Scotland, and health board annual reports vary considerably in their approaches to all types of corporate governance disclosure.

The Turnbull Guidance and the NHS

The Turnbull Guidance has been described as the last piece in the corporate governance jigsaw as it implements the "internal control" provision of the Cadbury Code of Best Practice. The guidance was first published in April 1999 with a revised version in June 2005.[18] Thus, its development began pre-Enron and continued post-Enron. It is the Turnbull Guidance that is responsible for the risk management focus of internal control including the all-pervasive risk registers and risk matrices. Various problems with risk assessment, risk management and risk policy reporting have been addressed by Belcher[19] and such problems may well have been the root cause of the recent spate of bank collapses. Nevertheless the technology of risk management has been transferred to the NHS. In particular clinical governance committees now form part of the overall governance structure of most NHS organisations including all NHS boards in Scotland that have clinical activities.[20] Risks arising in clinical situations were seen as the major area needing risk management, however, not all risk is clinical risk even in the territorial health boards and there has, therefore, been a question of how and where other risk is captured and managed. In the Greater Glasgow and Clyde Health Board, clinical risk is the responsibility of the medical director, and non-clinical risk is the responsibility of the human resources

12 NES is a special health board. Health board annual reports vary considerably in their presentation and contents. Corporate governance disclosures are not standardised.

13 January 2003. Latest version issued by the Financial Reporting Council (FRC) as *Guidance on Audit Committees* (London: FRC October 2008).

14 Code Provision C.3.1 – two non-executives for small companies.

15 Code Provision C.3.2.

16 Code Provision C.3.3; a provision that overlaps with FSA Listing Rules DTR 7.1.5 R and 7.2.7 R which are both satisfied by Code compliance.

17 Code Provision D.2.3

18 FRC, *Internal Control: Revised guidance for directors on the Combined Code* (London: FRC October 2005).

19 A Belcher, "'Something distinctly not of this character': how Knightian uncertainty is relevant to corporate governance" (2008) 28(1) *Legal Studies* 46–67.

20 Some of the special health boards in Scotland do e.g. the Scottish Ambulance Service; some do not e.g. NES.

director. Clearly, at board level, if not subcommittee level, the two strands of risk have to be brought together for overall risk to the health board to be considered. Some of the problems the NHS is encountering in relation to Turnbull's construction of all internal control being about risk management is due to the fractured governance terminology that has been adopted in the NHS where clinical, staff and corporate governance have their own definitions and silos of work, and what would be considered in the private sector to be (overall) corporate governance seems to have taken on the label "healthcare governance" or in the NHS in England "integrated governance":

> Integrated Governance is a co-coordinating principle. It does not seek to replace or supersede clinical, financial or any other governance domain. Rather it highlights their vital importance and their inter-dependence and interconnectivity.[21]

In Scotland the publication of National Standards for Clinical Governance and Risk Management has, if anything, added to the confusion as these standards present a muddled and overlapping list of governance and management elements,[22] including the aspiration of "public involvement" which has its origins in earlier political policy-making and is discussed below.

NHS Scotland governance developments

One of the Scottish National Party (SNP) Government's key policies for the NHS in Scotland is "public involvement". This policy can be traced back to two Patient Focus and Public Involvement Frameworks for 2003–05 and 2006–09 instituted under the previous administration.[23] These incorporated a set of targets for all NHS boards (territorial and special) in Scotland with progress being monitored by NHS Quality Improvement Scotland (QIS). The public involvement element has not so far been applied at board level. However, in 2008 the Scottish Government announced its desire to improve public and community involvement in local NHS services and proposed to introduce direct elections to NHS Boards in order to "ensure that the voice of local people and communities is heard when major decisions are being made" and promote "effective governance across the public services".[24] These proposals specifically mention governance, but also refer to strategy. Proposals were published as the *Local Healthcare Bill: Consultation* in January 2008. An analysis of responses to the consultation has been published and the Health Boards (Membership and Elections) (Scotland) Bill has been introduced in the Scottish Parliament. These events appear to have been timed approximately to coincide. The analysis purports to look forward to the Bill but the Bill was introduced in Parliament on 25 June 2008 and the analysis was published on the Scottish Government website on 3 July 2008. The analysis states that: "The issues raised as a result of the consultation will now be considered in the drafting of the Local Healthcare Bill." In fact, the differently named Health Boards (Membership and Elections) (Scotland) Bill had already been introduced. The analysis of responses acknowledges that there are problems with the idea of elected members on NHS boards, but manages to conclude that there is a need to proceed carefully, despite the fact that many respondents said they would favour not proceeding at all. The need for caution is followed through in the Bill's provisions for a pilot scheme:

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21 Department of Health, *Integrated Governance Handbook 2006,* Gateway Reference 5947 (London: DoH 2006), p 3.

22 *Clinical Governance and Risk Management – National Standards* (Edinburgh/Glasgow: NHS QIS 2005).

23 *Patient Focus and Public Involvement Framework 2003* (Edinburgh: NHS QIS 2003); and *Patient Focus and Public Involvement Framework, 2006–09* (Edinburgh: NHS QIS 2006).

24 Scottish Government, *Local Healthcare Bill: Consultation* (Edinburgh: Scottish Government January 2008).

4 Pilot scheme

(1) Ministers may by order (the "pilot order") appoint a day on which sections 1 to 3 are to come into force in respect of the Health Board areas specified in the order.

(2) Ministers may make one pilot order only (but this does not affect Ministers' power to modify or revoke the order).

(3) The pilot order may bring sections 1 to 3 into force with such modifications as Ministers consider appropriate.

5 Report on pilot scheme

(1) No later than 5 years after the earliest Health Board election to be held in a Health Board area specified in the pilot order, Ministers must publish a report containing— . . .[25]

The analysis also notes the limits of the consultation exercise as follows: "It should be noted that the findings contained in this report are specific to this consultation exercise and do not necessarily reflect the weight or range of views within the population as a whole."[26]

If factors are worth noting in the context of a consultation exercise, they are equally worth noting in the context of a local election process. The person elected will be the result of a specific process with voting on a specific day and a potentially low turnout. The views of the person elected will not necessarily reflect the weight or range of views within the population, or local community, as a whole. These factors appear to have been used in the context of the consultation process as a good reason for ignoring the many voices saying that the whole elected-members project should be shelved. NHS boards will just as easily be able to use similar arguments to set aside views of individual elected members if they claim to speak for the community. Also, many of the strategic and policy decisions that, in the private sector, would genuinely be made at board level are, in the NHS in Scotland, made by the Scottish Government Health Department (SGHD). Elected members may think that they will be "making the voice of the local community heard" on their NHS board, but may not realise the constraints placed on board decision-making by SGHD.

Some of the key contents of the Bill will now be summarised in order to point out some specific problems and some more general conceptual mismatches. The Bill provides for NHS Boards (territorial not special) in Scotland to have a number of directly elected members. The new health board structure will consist of the following types of member: (a) appointed members, (b) councillor members, and (c) elected members. The Bill also provides that the total number of councillor members and elected members of a board must amount to more than half the total number of members. One of the interesting aspects of the Bill is that the franchise is expanded to include those sixteen years and over. In relation to corporate governance, the most important aspects of the process are not specified in the Bill itself. Who is qualified to be a candidate in a health board election and the circumstances in which an individual may be disqualified from being a candidate are matters left for election regulations permitted by the Bill. The consultation process included questions about disqualification and eligibility criteria. On disqualification, the analysis of responses states that: "It was felt that the standard exclusions of those seeking election to the Scottish Parliament or local authority should be used. This would mean consistency of approach."[27]

25 Health Boards (Membership and Elections) (Scotland) Bill 2008.

26 Ibid., p. 11, para. 11.

27 Ibid., p. 19.

On eligibility, question 9 of the consultation asked: "What eligibility criteria should candidates meet (e.g. should they be resident in the Board area? Should there be any other qualifications?)."[28]

The analysis of responses only makes reference to the first suggested question. It states:

> There was strong feeling that the candidates for election to an NHS Board should be resident in that Board area. This, it was felt, would bring that necessary local experience and identity to the Board and allow communities to identify strongly with their elected representative on the NHS Board.[29]

The part of the question dealing with "other qualifications" is ignored, but the executive summary lists some concerns that include: "Concern that the skills that are brought to a Board by Members going through the Public Appointments process could be lost."[30]

For special health boards, which have no Local Authority members, the non-executive members all go through the public appointments process, with the single exception of the employee director. The author or this article is currently a non-executive member of the board of NHS Education for Scotland, a special health board with a budget of approximately £400 million per annum that has a wide education and training remit encompassing all healthcare workers. In particular, it is responsible for all postgraduate training of doctors, and programmes for dentists, pharmacists, nurses, audiologists, healthcare scientists, etc. I was appointed through the public appointments system. This included a job specification and a person specification, both including essential and desirable qualities, skills or qualifications to be found in an appointable candidate. These two lists could be described as the "qualifications" for appointment. This part of the appointment process is in line with private sector corporate governance guidance that suggests non-executive appointments should begin by identifying any skills gaps on the board as a whole. The NHS office I applied for had the audit committee "recent relevant financial experience" requirement as essential. I was appointed in June 2006, before the current SNP Government came to power. I understand anecdotally that the implementation of the public appointments system has become even more rigorous under the SNP. The interview process, organised by the office of the Commissioner for Public Appointments, results in names being sent to the minister who has the final say and makes the appointment. Recently, the minister has not dealt with this based on the paperwork alone but has called those named for a face-to-face meeting, in effect a further interview. This suggests that, in making non-executive appointments, selection of an applicant with the right skills, qualifications, and personal attributes is seen as important. This fits with the private sector view of non-executive appointments. However, the process of specifying the skills required and seeking the best match possible will be lost for all posts filled by direct election. There is no indication that the eligibility regulations will have any skills or qualifications elements. It seems that these regulations are likely to focus solely on residency. Given that the total number of councillor members and elected members of a board must amount to more than half the total number of members, the number of executive directors and appointed non-executives must amount to less than half. In order to keep within this rule, boards will either have to increase in number from their present size, or the number of appointed non-executives will have to be reduced. In general, it is thought that increasing the size of a board is likely to detract from the quality of its decision-making. It seems likely

28 Health Boards (Membership and Elections) (Scotland) Bill 2008, p. 18.

29 Ibid.

30 Ibid.

therefore that the introduction of elected members will result in a fall in the number of appointed non-executive members, and hence the concern about a possible loss of skills.

The Health Boards (Membership and Elections) (Scotland) Bill was introduced only weeks after the launch, jointly by the Scottish Government and NHS Scotland, of a Board Effectiveness Project. In May 2008, a national engagement event was held with the aim of disseminating some preliminary research results, discussing what constitutes best practice, and developing a performance tool to evaluate board effectiveness. This project was thought to be necessary following the financial and governance failures of NHS Western Isles which culminated in the removal of power from board members, the sending in of a task force, and detailed scrutiny by the audit committee of the Scottish Parliament. Dr Kevin Woods, Director General for Health and Wellbeing, Scottish Government, appeared before the Parliamentary Audit Committee in October 2008 and will have to report to it on progress again in May 2009. I was one of the participants at the national engagement event and one of the questions raised was how this initiative would, or could, add to the existing Good Governance Standard for Public Services.[31] Dr Woods' evidence to the audit committee on 8 October 2008 included the following statement:

> Let me add one general point on board effectiveness. Having reflected on what we can do if a whole board is in difficulty, we have begun some work on board effectiveness and the induction of non-executive and executive directors to board positions. We are developing specific training materials that will supplement the "On Board" guidance and will be aimed specifically at audit committee members and remuneration committee members. We are developing a board effectiveness tool – as it is called in the jargon – that boards can use to appraise themselves on the extent to which they are applying the guidance in documents such as "On Board". I kicked off that work earlier this year, and we are working towards launching that programme later this calendar year. That will be an important addition to the range of things that we do to ensure the effectiveness of boards as a whole. As I commented previously, we need to remember that one difficulty in the Western Isles was that the board as a whole did not function well.[32]

At the time of writing, very close to the end of the calendar year, the "board effectiveness tool" has not been launched. The concern for the quality of board effectiveness appears to have been driven almost entirely by the crisis in NHS Western Isles. If the board effectiveness tool is designed to assess compliance with existing guidance, it is likely to have recognisable corporate governance themes at its heart, for instance, the roles and necessary training of non-executive, and possibly executive, board members. This initiative appears to be aimed towards improvement of board members' skills and the exercise of those skills. However, the consultation process on directly elected board members has already registered a level of concern about the possible loss of boardroom skills as a consequence of the Health Boards (Membership and Elections) (Scotland) Bill. The needs for better, and better exercised, skills that have been identified in the wake of the NHS Western Isles crisis only serve to increase those concerns.

Public involvement, public participation, public interest

It is clear from the sequence of events and policy documents set out above that the idea of public involvement in the NHS in Scotland has been driven by political ideology rather than growing out of political theories of public involvement, public participation or the public

31 Independent Commission, *Good Governance Standard*, n. 6 above.

32 Proceedings of the Scottish Parliamentary Audit Committee, 8 October 2008, cols 686–7.

interest. The Scottish Government asserts that directly elected members will "ensure that the voice of local people and communities is heard when major decisions are being made" and promote "effective governance across the public services". The possible loss of governance skills identified in the previous section must raise questions about the overall impact of the elected members on the effectiveness of governance. The connections between directly elected members and accepted theorising about public participation, public involvement and the public interest are equally underdeveloped in the policy documents. The governance process implicit in the statutory provisions is a combination of electoral democracy (use of the ballot box to select some board members) and deliberative democracy (deliberation in the boardroom as a crucial mechanism for making "major decisions"). In this section, some of the theoretical difficulties associated with both voting and deliberation are highlighted. Firstly, the problems of using elections as a means of identifying the public interest have long been acknowledged:

> the use of direct methods [polls, interviews] of discovering what interests the public possesses can give at best only temporary opinions on transient issues . . . it is obvious that the opinions expressed by the public by means of the electoral process are practically never unanimous, nor even approach unanimity . . . accepting the results of elections as expressions of the public interest would involve the position that every decision made by the electorate is the best possible decision that could have been made, a position which most democratic theorists would probably wish to avoid.[33]

This leaves the problem of how to articulate a public interest. Benditt put forward a *collective* conception of the public interest as: "An act or policy is in the public interest not because at is in the overall interest of each member of the public, but because it promotes an interest of the public, i.e. an interest of anyone."[34] This definition does not answer the question of how to discover or identify a public interest. One answer is via increased public participation.[35] This is at least part of the reasoning in support of public participation in the sustainable development literature where it is believed that "effective participation in decision-making processes by local communities can help them articulate and effectively enforce their common interest"[36] In the sustainability literature, participation is also, somewhat contentiously, seen as the only approach to policy-making that can incorporate the needs of all segments of society, future generations and other species, and as leading to better social choices by increasing the evidence base for decisions.[37] Democratic participation is:

> . . . where people take part in policy making as citizens, not as experts or interest advocates. Here "participation" means the direct participation of amateurs in public policy making, allowing citizens to participate with administrators and experts on a more equal basis, creating structures for face-to-face interaction over time, and allowing citizens a share in decision making . . . The call for enhanced citizen participation is closely linked with a "deliberative" conception of democracy. This conception stresses the importance of on-going dialogue

33 C W Cassinelli (1958–59) "Some reflections on the concept of the public interest" 69 *Ethics* 48–61, at 60.

34 T E Benditt, "The public interest" (1973) 1972–73(2) *Philosophy and Public Affairs* 291–311, at 311. For further discussion of the public, or general, interest see E Klijn and C Skelcher, "Democracy and governance networks: compatible or not?" (2007) 85(3) *Public Administration* 587–608, at 603–4.

35 Little has been written on the public interest in a corporate context but, for one example, see J R Branston, K Cowling and R Sugden, "Corporate governance and the public interest" (2006) 20(2) *International Review of Applied Economics* 189–212.

36 S Baker, *Sustainable Development* (Abingdon: Routledge 2006), citing Brundtland, p. 42.

37 Ibid.

> between citizens. This contrasts with the more traditional forms of sporadic, passive, procedural participation, such as voting . . . This form of participation is not aimed at giving a voice to individual preferences or interests for their own sake. Rather, it aims at finding a voice for the common good.[38]

Deliberative democracy has also been contrasted with the dominant model of political scientists based on rational choice theory. That theory assumes fixed preferences or, at least, fixed ordering of preferences, whereas deliberative democracy is defined in terms of individuals participating in democratic processes amenable to changing their minds and preferences as a result of the reflection induced by deliberation.[39] One definition of deliberation is "the endogenous change of preferences resulting from communication".[40] Some of the theoretical difficulties in this area include the relationship between "deliberation" and "discourse", terms that are sometimes used as alternatives; and the relationship between deliberative modes of operation and more formal democratic modes such as voting. The "discourse" debate has been summarised as follows:

> To one school of thought, followers of Michel Foucault, a discourse is like a prison; it conditions the way people think. To another school of thought, influenced by Jurgen Habermas, discourse means precisely the opposite: it is pure freedom in the ability to raise and challenge arguments. The approach I take here [in a book on *Deliberative Democracy*] emphasizes contestation across discourses in the public sphere as a key component of democracy, so discourses are not prisons. On the other hand, discourses in the Foucauldian sense do exist, so discourse in the Habermasian sense cannot wish them away.[41]

The governance pressures to introduce directly elected members on NHS boards in Scotland undoubtedly come from the political imperative originating in the SNP's election manifesto. Public involvement in the NHS, via other mechanisms and below board level, had been NHS policy within the Patient Focus and Public Involvement Frameworks for 2003–05 and 2006–09. The Health Boards (Membership and Elections) (Scotland) Bill takes public participation to board level using direct elections, but, seemingly, with a view to the directly elected voice being part of the deliberative process in the boardroom. This means that other significant problems associated with deliberative democracy need to be addressed: Johnson has put these firstly, and generally, as a minimum requirement for "an account of how deliberative processes interact with non deliberative decision-making procedures like voting"[42] and, secondly, the need for a ". . .clearer understanding of how deliberative arrangements relate to . . . formal institutions".[43] The difficulties involved in coupling voting with deliberative decision-making could become the most intractable in practice. The elected members are likely to have stood for election with a particular manifesto, whether of their political party or on a single issue. This in turn may lead them to believe that they are mandated to argue or vote in a particular way at board meetings. This itself has two governance consequences: the first is the tension between a perceived electoral mandate and the exercise of normal directors' duties in decision-making; the second is the difficulty of imagining directly elected members engaging in meaningful

38 Baker, *Sustainable Development*, n. 36 above, p. 43.

39 J S Dryzek, *Deliberative Democracy and Beyond: Liberals, critics, contestations* (Oxford: OUP 2000).

40 S C Stokes, "Pathologies of deliberation" in J Elster (ed.), *Deliberative Democracy* (Cambridge: CUP 1998), ch. 5, pp. 123–39, p. 123.

41 Dryzek, *Deliberative Democracy*, n. 39 above, p. vi.

42 J Johnson "Arguing for deliberation: some sceptical considerations" in J Elster (ed.), *Deliberative Democracy* (Cambridge: CUP 1998), ch. 7, pp 161–84, p. 175.

43 Ibid.

deliberation (which assumes that preferences may be changed), again in the context of strong electoral promises.

Johnson also mentions the need for a ". . . clearer understanding of how deliberative arrangements relate to . . . formal institutions".[44] The difficulties of coupling a deliberative decision-making process at NHS board level with "formal institutions" should not be underestimated in the particular context of the NHS in Scotland. One of the strongest formal institutions in this context is the SGHD. Stokes, writing on "pathologies of deliberation", looks for "the influence of citizens' preferences on government policy".[45] While the SNP rhetoric appears to be providing a mechanism for bottom-up decision-making by NHS boards, overall NHS policy will remain firmly in the hands of the SGHD. There is likely to be little scope for elected board members to influence government policy, even assuming the processes of election to the board and board deliberation operate well. The SGHD exercises tight control over Scotland's national health policies and over the detailed annual health board plans that implement those policies.[46] Writing in the slightly different context of public "governance networks", Klijn and Skelcher conclude that:

> Engaging citizens in the development of policy often brings them into conflict at the end of the process with elected bodies like parliament or municipal councils. The studies . . . find that politicians initiated interactive decision making, but were reluctant to support the process or utilize the outputs in their own decision-making.[47]

Conclusions

The main aim of this article was to examine the governance reform pressures and processes affecting NHS boards in Scotland. The basic corporate governance "technologies" developed in the private sector have been transferred into the NHS in Scotland, including provisions arising from the writing and revision of codes of best practice, internal control constructed as risk management, the importance of non-executive skills and the exercise of skills by both executives and non-executives. The process of transfer that began shortly after the Cadbury Report in 1992 has continued into the post-Enron period. However, as noted in relation to the earliest transfer, the translation of private sector modes of organisational governance into the public sector is not without problems. The NHS has adopted governance terminology that has tended to overcomplicate the governance of an organisation by fragmenting it into staff, clinical and corporate governance. In Scotland, the publication of National Standards for Clinical Governance and Risk Management[48] has added to the confusion. These "standards" include some governance items, but also substantive delivery and management issues. Performance against the standards has been assessed by NHS QIS, an arrangement that was criticised in the Crerar Review and is to be changed:

> Independence is a fundamental principle of effective scrutiny and most scrutiny bodies have a degree of independence from government and from providers. One exception is health, where scrutiny by NHS QIS is internal to the health service, because NHS QIS is itself a special health board, which makes its independence less clear.[49]

44 Johnson, "Arguing for deliberation", n. 42 above.

45 Stokes, "Pathologies of deliberation", n. 40 above, p. 123.

46 Local Delivery Plans. The SGHD holds health boards to account for their performance against these plans.

47 Klijn and Skelcher, "Democracy and governance networks", n. 34 above, p. 597.

48 NHS QIS, *National Standards*, n. 22 above.

49 L D Crerar, *The Report of the Independent Review of Regulation, Audit, Inspection and Complaints Handling of Public Services in Scotland* (Edinburgh: Scottish Government September 2007), p. 42.

The use of "corporate governance" within the NHS to mean only one of several governance strands is another problematic use of terminology. The private sector understanding of corporate governance as an overall umbrella covering governance of the organisation as a whole has not transferred smoothly into the NHS setting. This is unfortunate as the failure of the board "as a whole" to function well was identified as a significant factor in the crisis in NHS Western Isles.[50] The Western Isles crisis, which was NHS Scotland's mini-Enron, has provided the impetus for the national board effectiveness initiative and the promise of a "board effectiveness tool". The tool is aimed at enhancing boardroom skills and assessing the use of those skills, but at the same time there are concerns that legislation introduced for directly electing health board members may result in the NHS in Scotland losing boardroom skills. The aspiration of this legislation is to "ensure that the voice of local people and communities is heard when major decisions are being made" and to promote "effective governance across the public services". An examination of some of the theoretical underpinnings and difficulties associated with the concepts of public participation, public involvement and the public interest, revealed that these aspirations are unlikely to be met. There are theoretical and practical difficulties associated with the Health Boards (Membership and Elections) (Scotland) Bill currently before the Scottish Parliament,[51] however an exploration of what good corporate governance in the public interest could mean, and could look like in practice, may be an idea that is worthy of being transferred towards the private sector.

50 Proceedings of the Scottish Parliamentary Audit Committee, 8 October 2008, col. 686–7.

51 The Bill passed Stage 3 on 12 March 2009 meaning Royal Assent could be as little as one month away.