



# evolution *or* revolution?

Changes in Britain's boards of  
directors from 1960 to 2010

SpencerStuart

## Sir Geoffrey Owen

Sir Geoffrey Owen is Senior Fellow at the Department of Management, London School of Economics, where he conducts teaching and research in the field of corporate strategy, corporate governance and international competition.

Sir Geoffrey was born on April 16, 1934. He was educated at Rugby School and Balliol College, Oxford, where he studied classics. After two years' national service in the Royal Air Force, he joined the *Financial Times* as a feature writer in 1958. He held several posts on that paper, including those of Industrial Correspondent, Industrial Editor, and US Correspondent based in New York. He was deputy editor of the *Financial Times* from 1973 to 1980 and editor from 1981 to 1990. He joined the London School of Economics in 1991.

He has written extensively in the field of business strategy and industrial performance. He has published three books: *Industry in the USA* (Penguin 1967), *From Empire to Europe: the decline and revival of British industry since the second world war* (HarperCollins 1999), and *The rise and fall of great companies: Courtaulds and the reshaping of the man-made fibres industry* (Oxford, 2010).

He also contributed a chapter on "The role of the board", in *The business case for corporate governance*, edited by Ken Rushton (Cambridge 2008), and he co-authored two other corporate governance studies — *The changing role of the Chairman* (published by the Chairmen's Forum in March 2006) and *Corporate governance in the US and Europe: where are we now?* (Palgrave 2006)

Sir Geoffrey was a non-executive director of Laird Group plc from 2001 to the end of 2006. He is currently chairman of the Wincott Foundation.

He is married with one daughter.

# evolution *or* revolution?

Changes in Britain's boards of  
directors from 1960 to 2010

Geoffrey Owen



# Contents

---

Foreword	5
The Spencer Stuart view	7
Executive summary	13
Introduction	17
The starting-point: passive shareholders and insider-dominated boards	21
The Bank of England steps in	27
The 1980s: the era of shareholder value	33
The Cadbury report and its successors	39
The dot.com crash and the banking crisis: a corporate governance failure?	49
Where are we now?	59
Conclusion	73
Glossary	77
About Spencer Stuart	79
Endnotes	80
Cartoon credits	84

## CONTRIBUTORS

We are grateful to the following for their considered views on the topics discussed in this book.

- |                        |                       |                    |
|------------------------|-----------------------|--------------------|
| > Lord (Peter) Brooke* | > Sir Roger Hurn      | > Sir Nigel Rudd   |
| > Lord (John) Browne   | > David Kimbell*      | > Rolf Stomberg    |
| > Donald Brydon        | > Sir Martin Jacomb   | > Martin Taylor    |
| > Alison Carnwarth     | > Huw Jones           | > Sir David Walker |
| > Sir Roger Carr       | > Sir David Lees      | > Steve Williams   |
| > Carolyn Eadie*       | > David Mayhew        | > Phil Yea         |
| > Mary Francis         | > Sir Peter Middleton |                    |
| > Tony Habgood         | > Sir John Parker     |                    |
| > Sir Christopher Hogg | > Kit Power*          |                    |
|                        | > David Rough         |                    |

\* Spencer Stuart UK chairmen

## Foreword

---

*When Peter Brooke set up Spencer Stuart's business in London fifty years ago, the firm's intention was to introduce modern "headhunting" to the UK market and to ensure wherever possible that the focus started in the boardroom.*

Over the past five decades we have been providing help, advice and people to Britain's business community and in doing so we have been able to observe at close quarters how the leadership of British companies has performed.

The environment has changed a great deal since the 1960s and the pace of change quickened with the publication of the Cadbury report in 1992. From that point on, our involvement with boards increased significantly.

The prospect of reaching our fiftieth birthday in 2011 prompted us to investigate a subject of great interest to us, and one that we hope will be of equal interest to you: namely, how the role of the board has evolved and why companies have come to be governed the way they are today.

During the course of our research we interviewed a variety of distinguished people with first-hand board experience. Their views on the change that has taken place on boards over five decades were invaluable to us.

Our study explores many issues, from the changing size and composition of the board to the trade-off between independence and knowledge; from the question of shareholder engagement to the correlation between corporate crises and governance codes. However, one clear theme that runs throughout is the growing importance of the chairman and the critical role he or she plays in the effectiveness of the board and the success of the company.

Chairing a board is a skilled occupation, requiring a high degree of competence and the ability to attract outside directors with the skills and experience needed, and then getting the best out of them. Above all, the chairman must complement the talents and personality of the chief executive; together they are the leaders of the company and their relationship is crucial.

We believe that the history of boards in Britain is both fascinating and important and we are greatly indebted to Sir Geoffrey Owen for his role in telling it. We hope that this study illuminates the past and provokes some debate about how boards will need to continue to adapt in the future.

Mark Stroyan  
Managing Director, Spencer Stuart  
London, March 2011



## The Spencer Stuart view

---

*Drawing from the report that follows, we have identified five pressing concerns that boards need to address.*



*"Now, I'd like to introduce to you our new non-executive director."*

## PREPARING THE NEXT GENERATION OF CHAIRMEN

Chairmen of the board occupy an increasingly critical role in major UK listed companies. The chairman's influence over not just the board but the organisation as a whole will continue to grow — and yet there is a dearth of truly high-class candidates with the versatility and personality confidently to carry out the chairman's role at Britain's largest companies.

In the past generation, the role has evolved from leader of the board to conductor of an orchestra. Successful CEOs evolved easily into directive chairmen. But executive success is only one of several attributes needed for the more subtle leadership required of the modern chairman. The range of skills, experience and wisdom required to be an effective chairman are not easily acquired, and no training is available except on the job. More thought is needed on how to prepare people for chairmanship; too many assumptions are made about who is likely to be effective in the role.

The truth is that neither CEOs nor CFOs are automatically suited to becoming board chairmen. Much depends on the structure of the businesses they have led. Take the critical skill of running a board meeting, for example: the chairman must draw out and listen to all points of view, synthesise the arguments and reach conclusions without appearing to dominate. A CEO who has run a business with multiple divisions may have developed some of the chairman's skills while leading the executive board (i.e. not being an expert in every division's activities). By contrast, a CEO who has run a unitary group may have a more directive style. Some CFOs make the transition more easily, thanks to their adeptness in influencing without appearing to lead. But for both types of executive, the bridge to becoming an effective chairman is longer and more exposed than it used to be.

In the coming decade, boards will be chasing a diminishing group of high-quality chairmen. Careful thought must be given to preparing the next generation of contenders for what is an increasingly difficult and critical role.

## THE RIGHT OF NON-EXECUTIVES TO SEEK ADVICE

As the burden on non-executive directors grows, they will require more structured support to enable them to discharge their duties properly. Their dilemma is that they are condemned to be at arm's length by virtue of spending a limited amount of time with an unfamiliar new company and not being allowed to come from a competing industry; yet at the same time, they are accountable to an unlimited extent should anything go awry. Although all directors are equally responsible in law, they cannot come to the table equally informed. For this reason, a number of companies already provide a mini-secretariat for non-executives, in addition to the independent advice to which they are entitled.

An effective mini-secretariat enhances non-executives' knowledge of the business and, providing it operates in a non-destabilising way, bridges the gap in understanding between them and the executive directors. This small support team can be attached to the company secretary's department, briefed by the senior independent director, and be at the beck and call of the non-executives who can use it to access anyone — and any data — in the company. A secretariat cannot of course replace a good non-executive's well-informed instinct, but more companies could follow this example.



ALEX, DAILY TELEGRAPH, 2007

The creation of supplementary information channels should not concern CEOs if set up and managed in a constructive way.

## WOMEN ON BOARDS

Headhunters are rightly expected to help chairmen put together effective and diverse boards, and gender imbalance has become a major challenge to board effectiveness as well as governance. To date the market alone hasn't provided the answer — there has been a shortage of women with the relevant experience and backgrounds who can provide high-quality coverage across the range of sectors represented in the FTSE. But the picture is changing. In our view there is a pool of potential candidates if boards are prepared to look less at proven general management experience and more at talent and potential — to consider creative ideas and take some calculated risks.

Lord Davies's February 2011 report on the lack of women in boardrooms adds to the pressure on chairmen to act, highlighting the extent to which the UK has begun to fall behind other economies that addressed this problem earlier and more aggressively. The Davies report will be an important catalyst for change and we wel-

*"We're a great board and will  
continue to be indefinitely.  
I've arranged to clone us all!"*



come its recommendations, both for raising the number of women in boardrooms and combating the “under-representation of women in senior management generally”.

New talent pools need to be explored if numbers of women on boards are to rise, either outside plcs or further down the plc hierarchy. An element of sensible compromise may be needed when it comes to board-level experience. In the longer term, companies must make greater efforts to sponsor and develop the careers of high-potential women to the point where they become credible board candidates inside or outside their companies.

Boards must never compromise on quality; positive discrimination all too often turns out to have a negative consequence. For example, one must guard against a cynical chairman reducing the number of executive directors simply for the sake of achieving the target of 20 or 25 per cent women.

As more women are appointed to non-executive directorships, boards must prioritise their successful integration. Providing chairmen are confident that an appointee, male or female, meets the board’s needs, they are bound to create an environment where the new non-executive director can succeed.

## THE VALUE OF SERVING EXECUTIVES ON BOARDS

It is in the long-term interests of business that more executives serve on boards. In 2010 only 41 per cent of FTSE 150 CEOs and CFOs sat on an outside board. It is a concern that so much experience and talent is unavailable to FTSE boards, and that too many executives are not getting the benefit of serving on an outside board. This is seemingly intractable: the task of the non-executive is increasingly onerous and it is difficult for boards to expect serving executives to put in the time. A number of board chairmen exercise wise pragmatism and are prepared to have twin-track directors — portfolio/professional directors in the majority, with one or two current executives whose level of involvement and time commitment (for example on committees) is slightly lower. More should follow their example. Boards that appoint executives from other com-

panies must provide them with sufficient preparation to become non-executives, since they are being asked to exercise an entirely different skill and perspective from their day jobs. Induction processes for new non-executives are becoming increasingly systematic and the quality is improving. But there is much further to go.

### CREATING MORE ENGAGED BOARDS

It is welcome that boards are getting smaller. However, a smaller board often makes more demands on its non-executives than a larger one. A growing number of boards are asking non-executives to attend on each of the principal committees. This won't work for every company, but boards that are able to do this will end up with highly engaged non-executives and far shorter presentations from committee chairmen. Smaller, more engaged boards are a virtuous minority. A number of larger boards would benefit if the chairman asked whether too many executives are present and whether all the non-executives are really necessary. Because it is always uncomfortable to change the status quo, this is perhaps a particular task for incoming chairmen.

## Executive summary

---

*Corporate governance in Britain's listed companies has been transformed over the last fifty years. The old-style insider-dominated board, made up mainly of full-time managers and led by an executive chairman, has given way to boards in which at least half the seats are held by non-executive directors and the chairman is usually an outsider, not a former employee of the company.*



"The Board's meeting at nine o'clock - You bring the Smoke, I'll bring the mirrors."

The purpose of this paper, based partly on interviews with current and former chairmen, is to describe how and why these changes took place, and to assess the strengths and weaknesses of the present system.

### **THE STARTING-POINT: PASSIVE SHAREHOLDERS AND INSIDER-DOMINATED BOARDS**

Corporate governance was not a big topic for debate during the 1960s. While there was concern about the quality of British management (hence the creation of US-style business schools in London and Manchester), the focus was on the executives at the top of companies, not on their boards and still less on their non-executive members. More than half the shares in listed companies were held by private investors, who had neither the ability nor the incentive to seek to influence the companies in which they held shares.

### **THE BANK OF ENGLAND STEPS IN**

The collapse of Rolls-Royce in 1971 was one of several corporate crises which set in train a series of attempts, largely orchestrated by the Bank of England, to correct what were seen as two weaknesses in Britain's governance arrangements: boards of directors which were too subservient to the executives and failed to exercise their supervisory responsibilities, and the reluctance of institutional investors to intervene in the affairs of badly managed companies.

### **THE 1980S: THE ERA OF SHAREHOLDER VALUE**

The recession of 1980–81 exposed the frailty of some of the country's leading industrial companies, and the Bank of England was involved in trying to ensure that the viable ones were kept afloat. Much of the Bank's activity was concerned with persuading creditors to work together in finding a solution to the troubled companies' financial problems, but the longer-term issue was how to prevent crises from occurring. The Bank continued to argue for stronger boards, and helped to set up a new body, PRO NED,



to promote the wider use of non-executive directors. Companies came under greater pressure from investors during this period to focus on shareholder value, and non-executive directors were increasingly seen as guardians of the shareholder interest.

### THE CADBURY REPORT AND ITS SUCCESSORS

Several corporate scandals in the late 1980s and early 1990s highlighted the inability of boards of directors to curb self-serving behaviour on the part of over-powerful chairmen. This led to the establishment of the Cadbury committee, which set out a code of good conduct for boards and for their non-executive members. It also introduced the comply-or-explain concept, whereby companies were required either to comply with the code, or, if they chose not to comply, to explain the reasons for that decision to shareholders. By the end of the decade, following two further inquiries (the Greenbury and Hampel reports), most companies had adapted their governance arrangements in line with what was called the Combined Code.

### THE DOT.COM CRASH AND THE BANKING CRISIS: A CORPORATE GOVERNANCE FAILURE?

The collapse of the dot.com boom in 2001 and the banking crisis of 2008–09 raised serious questions about the effectiveness of the corporate governance system. Two inquiries were carried out: the Higgs review of the role of non-executive directors, and the Walker review of corporate governance in banks and other financial institutions. The latter raised two issues which were also relevant to non-financial companies: whether the definition of independence in the Combined Code was too restrictive, effectively excluding some knowledgeable people from serving as chairmen or non-executive directors; and how best to encourage shareholders to engage more actively with investee companies. Following the Walker review the Financial Reporting Council established a stewardship code aimed at encouraging closer interaction between shareholders and companies.

## WHERE ARE WE NOW?

Our interviewees were broadly agreed that the corporate governance reforms that had been introduced since Cadbury had been beneficial. At the same time there was a frank recognition that some of the boards on which they had served had performed poorly, and a degree of concern about how some elements of the corporate governance system were working. The anxiety centred on five issues: the chairman/CEO relationship; the independence criteria for the appointment of board members; an over-preoccupation with process; the reluctance of some non-executive directors to challenge their executive colleagues; and the unsatisfactory relationship between boards and shareholders.

## CONCLUSION

Over the past fifty years the UK has arrived at a corporate governance system which is different from, but not necessarily better than, that of other industrial countries. There is no case for radical change, though some of the rules may need to be made more flexible. The challenge is to make the existing system work better. This means less focus on process and more on people and how they behave; less on rules and guidelines and more on the internal dynamics of the board, on identifying men and women with the right characteristics for board positions and training them well. If progress is to be made towards more well-functioning boards and fewer dysfunctional ones, a higher priority must be given to preparing chairmen for a role which has a special importance in the British system — part-time in most companies but much more than non-executive, and more crucial to board effectiveness than was envisaged at the time of the Cadbury report.

# Introduction

---

*The governance of Britain's listed companies has gone through profound changes in the last fifty years. The composition of the board of directors, the role of the chairman, the relationship between directors and shareholders — these and other elements in the corporate governance system look very different today from the arrangements which prevailed in the 1960s and 1970s.*



*"That's not just my opinion — it's yours, too."*

BRAD ANDERSON, WALL STREET JOURNAL, 1950S

The old-style insider-dominated board, consisting mainly of full-time executives, has been largely replaced by boards with a majority of independent directors whose task is not just to advise, but also to keep a watchful eye on the performance of the management team and to make changes when necessary. Most companies at the start of the period were led by an executive chairman, sometimes called chairman and managing director. Now the common though not universal practice is for the chairman to be independent — not a current or former employee of the company — and often described as non-executive, although that title, as recent events have shown, may understate the responsibilities that go with the job.

What has driven these changes, and have they made for more effective boards and more successful companies? This paper, based partly on interviews with current and former chairmen and with investment managers, highlights some of the events — often involving corporate crises or scandals — that prompted intervention by the regulatory authorities, leading to rules or guidelines with which all listed companies were expected to comply. The most recent of these episodes, the banking crisis of 2008–09, has raised questions about whether some parts of the corporate governance frame-



ALEX, DAILY TELEGRAPH, 2007

work that has taken shape over the past twenty years need to be rethought. In particular, the requirement that the chairman and a majority of the non-executive directors should be independent may have led to the appointment of people who had insufficient knowledge about the industry in which the company was competing.

The focus of the paper is on British corporate governance and its impact on board effectiveness, but it also makes comparisons with other countries, principally the US. The US has a different approach to regulation than the UK, but the two countries have similar legal systems and similar shareholding structures, and the stock market plays a larger role than in most Continental European companies. In some areas of corporate governance — for example, the introduction of audit committees — the US gave a lead which was later followed in the UK.

The restructuring of boards which has taken place during the fifty-year period has to be seen in the context of the changing business environment. Most companies are far more exposed to international competition than they were in the 1960s, and this has been a powerful stimulus for rethinking their strategy and organisation, including the structure of boards. There have also been changes in ownership — first the rise of institutional investors, principally pension funds and insurance companies, which replaced private shareholders as the dominant owners of listed companies, and more recently the influx of non-traditional and often non-British investors, including hedge funds, some of which have different time horizons and different objectives from UK-based institutional shareholders.

Adding to these pressures is the greater public scrutiny to which listed companies, especially large ones, are now subject. They are expected to be good citizens and to demonstrate their value to society. Issues such as environmental protection and human rights loom larger than they did fifty years ago. Any shortcomings

in these areas are likely to attract the attention of the media and to damage the company's reputation.

Thus today's boards of directors face a different set of challenges from the ones their predecessors had to deal with. How well equipped are they to meet these challenges, and have the corporate governance reforms helped them to do so?

## The starting-point: passive shareholders and insider-dominated boards

---

*There were anxieties about British industrial performance during the 1960s but the focus was more on the quality of management than on corporate governance or the structure of boards. Most boards consisted of current or former executives, plus a few outsiders who had commercial links to the company or relevant skills and business contacts.*



*"Then it's moved and seconded that the compulsory retirement age be advanced to ninety-five."*

PETER ARNO, NEW YORKER, 1963

Corporate governance was not a big topic for debate in the UK during the 1960s. This was not because British companies were thought to be running their affairs well. On the contrary, there was anxiety from the late 1950s onwards about the poor performance of British industry compared to its counterparts on the Continent and in the US. One response was the establishment of two US-style business schools in London and Manchester. Another, under a Labour government, was the creation of the Industrial Reorganisation Corporation (IRC), charged with promoting mergers in industries that were thought to be too fragmented to compete successfully in world markets. Although the stated purpose of the IRC was to promote economies of scale, much of its activity was concerned with identifying the best-managed firm in an industry and encouraging it to take over its weaker competitors.

Takeovers were seen as a way of getting bad management out and good management in, but the focus was generally on the chairman and managing director of the company concerned, not on the board and even less on its non-executive members. Most industrial companies during this period had boards consisting of full-time or former executives, together with a few outsiders who either provided services to the company, such as its merchant banker, accountant or lawyer, or had relevant skills and business contacts. Some boards also included men (rarely women) who had distinguished themselves outside business, such as retired politicians, civil servants or generals.

Imperial Chemical Industries in 1960 had a board of twenty, of whom fifteen were full-time executives. The outsiders included Lord Chandos, chairman of Associated Electrical Industries, Lord Glenconner, a director of Hambros, and D.J. Robarts, chairman of National Provincial Bank. (ICI's chairman, Sir Paul Chambers, also sat on the board of National Provincial; cross-directorships of this kind were common during this period.) Courtaulds' board in the mid-1960s consisted of twelve executives and three non-executive directors, of whom one was a former manager and the others were senior Conservative politicians, Lord Butler and Lord Eccles. Tube



Investments, an engineering group, had eleven directors including three outsiders who were chosen “for their general industrial, commercial and scientific experience”.<sup>1</sup>

Tube Investments, in common with many companies, had a chairman who was also sole managing director. (The title “chief executive” did not come into general use until the 1980s.) Others separated the two top posts, and the balance of power between these two individuals varied from company to company. At the General Electric Company (GEC), for example, Arnold (later Lord) Weinstock was managing director, and a more powerful figure than the chairman. On the other hand, one of our interviewees recalled being told by his chairman soon after being appointed managing director: “I am the chairman, you are the managing director, and you will bloody well do what I tell you.”

Outside directors served mainly as sounding boards and advisers, not as monitors of management. “The idea of independent directors”, one former chairman told us, “wasn’t thought of, talked



*“This is the part of capitalism I hate.”*

JOSEPH MIRACHI, *NEW YORKER*, 1965

about, or even understood in those days; the outsiders were there for the particular bit of advice they could give.” American boards had a similar structure. In 1960 only 25 per cent of the directors of US quoted companies were independent — that is, not current or former employees, and not dependent on the company as a source of income. This period has been described as “the high-water mark of managerialism in US corporate governance, in which boards were largely passive instruments of the chief executive officer, chosen by him and strongly disinclined to challenge his decisions or authority”.<sup>2</sup> Almost all big US companies combined the posts of chairman and chief executive.

Except at times of crisis or extreme underperformance, the chairman of the typical British company was not much constrained by shareholders. In 1960 more than half the shares in British listed companies were owned by private individuals who had little incentive or ability to influence what management was doing. Most boards saw shareholders as one of several constituencies whose interests they had to take into account; the idea that their prime duty was to maximise shareholder value would have seemed an alien concept. “We saw shareholders as a necessary evil”, one of our interviewees recalled.

Yet relations with shareholders were beginning to change as the proportion of shares held by institutional investors increased. Some of these institutions were willing to take action when an investee company was performing poorly. A celebrated case was the role played by Prudential Assurance in removing Bernard Docker from the chairmanship of BSA, a Midlands engineering company, in 1956. A more striking intervention came at the end of the 1960s when several City institutions engineered a change of management in Vickers. This company, one of the country’s largest industrial groups, was run by an ex-civil servant, Sir Leslie Rowan — he was chairman and chief executive — and profits were declining. In 1969, following an abortive attempt by two senior executives to restructure the top management (see box, opposite), Rowan found himself under attack from the City. Kenneth (later Lord) Keith, head of the merchant bank Hill Samuel, together with

## The Vickers affair in 1969–70

In the months preceding the intervention by City institutions in Vickers, senior managers in the company were openly pressing for changes in the board. The two managers responsible for planning in the head office, I.P. Coats and J.S. Bouton, submitted a memorandum in November 1969 which made recommendations for reconstructing the board and separating the roles of chairman and chief executive. “They argued for a complete separation of the functions of determining strategy and exercising it. On this proposition they thought that the board should comprise only the chairman, the chief executive and the non-executive directors. Below the board there should be a management company to advise and assist the chief executive.”

Harold Evans, *Vickers against the odds 1957/77*, Hodder and Stoughton 1978, pp 161–2

Prudential, Britannic Assurance and Cables Investment Trust, told him that changes in the board were essential. The outcome was the recruitment of a new chief executive from outside Vickers, followed soon afterwards by Rowan’s resignation and his replacement as non-executive chairman by Lord Robens, formerly chairman of the National Coal Board.<sup>3</sup>

The Vickers affair was described by *The Times* as marking “a strategic change of policy by leading institutions which now accept they must take an active interest in the management of the companies in which they invest”.<sup>4</sup> But, to the extent that the institutions intervened, they did so directly with the chairman; they did not look on non-executive directors as instruments for bringing about the changes they wanted. That attitude was understandable, since many of the outside directors, to quote one critical study, were appointed “for reasons that have nothing to do with the contribution they can make to the business — because they are old friends of the chairman, because they are the company’s solicitor or account-

ant, because they are well-known and prestigious, because a merchant banker thought an outside name might be useful at the time of going public”.<sup>5</sup> The possibility that a board of this sort might be partly to blame when companies got into trouble did not come to the fore until the 1970s.

## The Bank of England steps in

---

*During the 1970s the issue of corporate governance loomed larger than in the previous decade. Several corporate collapses were blamed in part on dysfunctional boards of directors.*



*"You've been gobbling up too many companies too fast."*

DELBERT POLSTON, WALL STREET JOURNAL, 1970S

The collapse of Rolls-Royce was the most spectacular of several corporate crises in the early 1970s which had important consequences for British corporate governance. This company had developed an innovative engine, the RB-211, and had sold it to Lockheed in the US for installation in a new wide-bodied airliner. However, it was a fixed-price contract and development costs had been seriously underestimated. By 1971, despite substantial support from the government, the company was in desperate financial straits. A receiver was called in, and the aero-engine side of the company was taken over by the government; Rolls-Royce remained in the public sector until privatisation in 1987.

The Bank of England had participated in the rescue negotiations, and its officials were convinced that the crisis was due in part to the failure of the board to recognise the risks that the company was running with the RB-211 contract; also to blame were the company's institutional shareholders, who should have been more active in monitoring what was going on. These two weaknesses, in the Bank's view, were not confined to Rolls-Royce; they were rife throughout British industry. What followed was an energetic attempt by the Governor of the Bank, Leslie (later Lord) O'Brien, supported by the government, to bring about a reform of British corporate governance on these two fronts.

In 1972 the Bank set up a working party made up of representatives from the principal investor bodies (including the British Insurance Association and the National Association of Pension Funds), to examine the feasibility of "a central organisation through which institutional investors, in collaboration with those concerned, would stimulate action to improve efficiency in industrial and commercial companies where this was judged necessary". The Bank had in mind a strong, well-staffed body that would have the power and resources to take initiatives, but this proved too ambitious for some members of the working party, who were reluctant to cede authority to a central organisation. An Institutional Shareholders Committee was set up in 1973, but, much to O'Brien's disappointment, it was formed without any executive management, and its chairmanship and secretariat rotated among the various institutional associations.

The Bank also persuaded the Confederation of British Industry to set up a committee, chaired by Lord Watkinson, “to examine the role, responsibilities and structure of the boards of public companies”. Its report, published in 1973, recommended that boards should include independent directors who were not financially dependent on the company, that companies should state in their annual reports which directors were non-executive, and that the posts of chairman and chief executive should normally be separated, although “this is a matter on which some flexibility is essential”.<sup>6</sup> Recognising that the supply of suitable candidates for non-executive directorships was limited, the committee urged larger companies to allow some of their senior managers to serve on other boards.

The Watkinson report came at a time when the European Commission was proposing, through the draft Fifth Directive on company law, that all European companies above a certain size should establish a two-tier board on the German model, with employees represented on the upper tier. This was anathema to most British business leaders, and a subsequent attempt by the Labour government, through the Bullock committee in 1977, to appoint employee directors to the unitary board was shot down by opposition from industry. The possible attractions of the two-tier structure — principally the clear separation of the monitoring and managing functions at the top of a company — remained a topic for discussion in Britain, but there was little support for it in business circles.

The Bank’s case for stronger boards was reinforced by the deep recession of 1974–75, which put several major companies under severe financial strain. Gordon (later Lord) Richardson, who had taken over as Governor from Leslie O’Brien in 1973, appointed an Industrial Adviser, Sir Henry (later Lord) Benson, who as senior partner in Coopers and Lybrand, the accountancy firm, had been closely involved in several corporate crises; he had also served on the Watkinson committee. Benson was convinced that most of the company failures could be blamed on ineffective and ill-structured boards. As he wrote later in his autobiography, too many non-executive directors were yes-men appointed by the chairman to support his own position; “they want the security of a directorship on a

good board, but are not willing to face their special and particular responsibilities”.<sup>7</sup> Benson was also concerned about the supply of suitable directors, and keen that larger companies should make their younger managers available to serve on other boards.

In a speech to the Institute of Directors in 1978 Richardson emphasised the importance of outside directors. It was essential, he said, that management’s plans should be subjected to critical independent scrutiny.<sup>8</sup> “Outside directors must become more aware of their supervisory responsibility towards management.” This theme was echoed in a government White Paper on the conduct of company directors. If non-executive directors were to supervise effectively, they “need free access to management information and there need to be enough of them. One or two non-executive directors on a board which is twenty strong are unlikely to exercise real influence.”<sup>9</sup>

In promoting an enhanced role for non-executive directors the authorities were to some extent following the American example. As in the UK, the impetus for change in the US came from corporate disasters at the start of the decade. The bankruptcy of Penn Central in 1970 was blamed in part on the passivity of the company’s directors, who, “like the directors of many other companies, had been neither advisers nor monitors but figureheads”.<sup>10</sup> In 1972 the Securities and Exchange Commission recommended that every listed company should establish an audit committee composed of independent directors, and this was later incorporated into the New York Stock Exchange’s listing rules.

Audit committees were set up by several British companies during the 1970s, although they were not required by law or by the London Stock Exchange to do so, and this was part of a gradual move in the direction urged by Leslie O’Brien and Gordon Richardson.<sup>11</sup> A survey of board composition carried out in 1979 and published in the Bank’s Quarterly Bulletin reported that the number of non-executive directors on the boards of the 1,000 largest companies had increased over the preceding four years, while the size of boards was unchanged.<sup>12</sup> (The average size of industrial company boards during this period was about ten; banks and financial institutions tended to have larger boards — for an extreme case



see box). Of the top 250 companies 63 per cent had three non-executive directors or more, and 34 per cent had five or more. As the Bank's article noted, there was no guarantee that non-executive directors were effective, but the increase in their number "indicates growing acceptance of their role and is therefore encouraging".

Some companies were becoming more rigorous in their choice of non-executive directors, and although methods of recruitment were still informal (there was little involvement by executive search firms in recruiting outside directors) the appointees were by no means all cronies of the chairman. At Courtaulds, for example, Sir Arthur Knight, who took over the chairmanship from Lord Kearton in 1975, believed that the absence of effective non-executive directors had contributed to poor decisions during the previous decade. He recruited two strong-minded businessmen and one ex-civil servant to the board, and although they represented a minority on a twelve-person board they had significant influence during Knight's chairmanship.

A typical view during this period was that the role of non-executive directors was "to provide a window on the world, to give a fresh perspective, to avoid inbreeding and to [allow companies to] draw on their experience".<sup>13</sup> But there was also a degree of scepticism.

### The evolution of boards: the case of Barclays Bank

In the 1960s the board of Barclays Bank had more than forty members, most of whom were either members of the founding families or full-time bank executives. There was also a sprinkling of distinguished names, including Marshal of the Royal Air Force Viscount Portal of Hungerford, Lord Cornwallis, the Earl of Woolton, and Viscount Knollys. The size of the board was gradually reduced over the next few years, coming down to twenty-three in 1980. It remained at that size until the 1990s when further reductions were made. In 2011 the board had thirteen members, of whom two were executives and the remaining eleven, including the chairman, were independent.

One chairman told an interviewer: “Non-executives are supposed to fulfil two roles — commercially as a check on management and to give an external perspective. In fact they never have time to get to grips with the problems ... For the external view we use our merchant bankers and other advisers. Non-executives are unnecessary; did you hear of a part-time brain surgeon?”<sup>14</sup>

Some companies were run as one-man fiefdoms, with outside directors, if there were any, playing a purely decorative role. In a report on London and County Securities published in 1976 inspectors from the Department of Trade described the chairman, Gerald Kaplan, as “a classic tycoon, ruthless if devious in his methods”, who exerted an “extraordinary power of fascination” over the board; non-executive directors were ill-informed about many important transactions and failed to recognise their responsibilities to shareholders.<sup>15</sup> Another tycoon, Tiny Rowland of Lonrho, was criticised in a Department of Trade report for failing to disclose information to the board or to the shareholders.<sup>16</sup> “A company needs a board that can provide an independent check on the executive, and Lonrho did not have such a board.”

While Lonrho and London and County were hardly representative of British industry, it was clear that the reforms set in train by the Bank of England had a long way to go.

## The 1980s: the era of shareholder value

---

*With investors putting companies under strong pressure to focus on shareholder value, the monitoring role of non-executive directors — preventing managers from building their own empires to the detriment of investors' interests — assumed greater importance during the 1980s.*



*"I'll ask for your opinion George — when you've been on the board for five or more years."*

When Margaret Thatcher's Conservative government took office in 1979, her first priority was to bring inflation under control. The combination of high interest rates and an over-valued pound precipitated a severe recession which brought several industrial companies to the brink of bankruptcy. As in 1974–75, the Bank of England took an active part in helping companies to survive, with David (later Sir David) Walker, who had joined the Bank from the Treasury in 1977, playing a leading role. Walker and his colleagues sought to persuade a troubled company's banks — often a dozen or more, including several American institutions — to cooperate in phasing loan repayments over a longer period and in putting the company's finances on a sound footing. In several cases the Bank also insisted on a change in top management. At the Weir Group, for example, a Scottish engineering company, the existing chairman was replaced in 1981 by a well-regarded industrialist, Sir Francis (later Lord) Tombs, who spent two years restoring the company to health. Other companies in which the Bank's intervention led to top management changes included Dunlop, Westland and the computer company ICL.

Bringing in a company doctor was an emergency response to a crisis, but the Bank continued to argue that crises were more likely to be avoided if companies had balanced boards with strong independent directors. There were too many cases — the Distillers Company, the dominant producer of Scotch whisky, being an extreme example — where passive boards had allowed once-powerful companies to slide into genteel decline. As one of our interviewees remarked, “apart from turning up for lunch and inspecting the wine cellar, the non-executive directors had no idea why they were there”. A professionalisation of the boardroom was urgently needed.

In 1982 the Bank persuaded the Stock Exchange, the clearing banks and other City institutions to set up a new body, PRO NED, to act as an advocate for independent directors. Chaired first by Sir Maurice Laing and later by Sir Adrian Cadbury, PRO NED had a missionary role: to sell the virtues of having more and better non-

executive directors. As Jonathan Charkham, an ex-civil servant who ran PRO NED until 1985, wrote later, “At the time a great many companies had relatively few non-executive directors of sufficient calibre and independence, though some had bloated boards studied with great names. Companies needed a supply of able and independent directors chosen methodically; it was PRO NED’s second task to provide an additional source of names.”<sup>17</sup>

By 1985 PRO NED’s success rate was running at about fifty appointments a year, and, with executive search firms becoming more active in this field, the shift towards a larger non-executive presence on boards appeared to be accelerating.<sup>18</sup> In that year, however, the Bank published another survey which was not wholly encouraging.<sup>19</sup> The survey showed that two in five of the top 1,000 companies had fewer than three non-executives, and in only one out of five were non-executives in a majority. In many cases the non-executive component included former employees and people with commercial links to the company. The Bank was unhappy about this, since non-executive directors, as well as being independent of management, “should not be constrained by financial considerations from pressing their view, if necessary to the point of resignation”. The Bank was also disappointed that less than half the companies indicated which directors were non-executive, and only 13 per cent provided biographical details. “Companies’ reports and accounts are in most cases a poor guide to the range of skills and breadth of experience on the board. This has significance not just for existing and prospective shareholders but ultimately for the efficient working of the capital markets.”

That some outside directors were failing to exert effective control over dominant chairmen was highlighted by the Guinness affair in 1985–86. The methods used by Ernest Saunders, chairman of Guinness, to engineer the takeover of Distillers were subsequently found to be illegal and led to Saunders and several collaborators being imprisoned. At the time of the takeover Saunders had an acquiescent board consisting mostly of close associates. Several of them were later replaced, partly at the Bank of England’s behest, by

strong outsiders whose monitoring responsibilities were spelt out in revised articles of association.

In 1987 PRO NED published a set of guidelines, recommending that companies should appoint a minimum of three non-executive directors constituting about a third of the board, and that audit and remuneration committees should have a majority of outside directors. But, as the Bank of England showed a year later in its final report on board composition, only three in five of the largest companies complied with these guidelines.<sup>20</sup> The trend towards more non-executive directors had stalled. The lack of progress was not due, in the Bank's view, to any lack of suitable candidates, but appeared to reflect a degree of satisfaction with an executive-dominated board. Noting that the executive component in most cases included the chairman, the Bank was concerned that the accountability of managers to independent supervision was significantly less than in other countries, such as Germany, the Netherlands or the US.

The reference to Germany seems surprising in view of the widespread aversion in Britain to two-tier boards, and perhaps reflected some support within the Bank for a system in which the supervisory role of outside directors was more clearly defined than in UK. But the principal influence on British corporate governance during

*"Harris, when I said 'Any questions?' it was only a figure of speech."*



the 1980s came from the US, where the mechanisms by which companies and their managers were governed were going through an important change.<sup>21</sup>

Institutional investors in the US were becoming more powerful, and more insistent that shareholder interests should be given higher priority. This meant, among other things, dismantling many of the conglomerates that empire-building managers had created during the 1960s and 1970s. “The decade was marked by an emergent belief about shareholder value as the ultimate measure of corporate success and by the deepening acceptance of a governance model focused on the monitoring board composed of independent directors. The hostile takeover was a catalyst for both developments.”<sup>22</sup> By the end of the decade the boards of most large US companies had a majority of non-executive directors, and fewer of them were former employees or had commercial links with the firm. There was also some pressure from academics and other outside commentators for a separation of the roles of chairman and chief executive, although only a minority of US companies followed that practice.<sup>23</sup>

In the UK, several corporate predators were roaming the scene, and they often targeted poorly managed conglomerates which had destroyed shareholder value. There was also an influx of American investment banks into the City, partly stimulated by the Stock Exchange reforms — known as Big Bang — which took place in 1986. These reforms made it easier for foreign institutions to build up their securities business in the UK, and firms such as Goldman Sachs and Morgan Stanley became influential as advisers to British companies. A partial Americanisation of British business was under way.

UK-based institutional investors were more active during this period, with insurance companies and pension funds pressing for management changes in under-performing companies. The National Association of Pension Funds set up several “case committees” to examine problem companies and to take action when necessary. An attempt was also made to strengthen the Institutional Shareholders Committee to facilitate more coordinated interven-

tion by the institutions; one suggestion was that the ISC might appoint investment bankers to develop alternative business plans in troubled firms, and maintain lists of acceptable non-executive directors.<sup>24</sup> As in the 1970s, however, the separate investor associations were reluctant to cede power to a central body, and the main role of the ISC continued to be to formulate general policy positions.



## The Cadbury report and its successors

---

*The 1990s saw the emergence of a distinctively British approach to corporate governance, based on the guidelines set out in the Cadbury report. A central element was the comply-or-explain principle which was widely imitated outside the UK.*



*"Rest assured as chairman I have a very close working relationship with my chief executive."*

The late 1980s and early 1990s were marked by a series of corporate scandals which highlighted the apparent inability of boards of directors to curb self-serving behaviour on the part of over-powerful and unscrupulous chairmen or chief executives. Two notorious cases were the looting of the Mirror Group pension fund by Robert Maxwell and the accounting irregularities at Polly Peck.

Part of the problem was seen to lie in the inadequate or inaccurate financial information that was provided to the board by the company's management. In 1991 the Financial Reporting Council (which had been set up in the previous year), together with the London Stock Exchange and the accountancy profession, established a committee under Sir Adrian Cadbury to examine ways of improving the quality of financial reporting. The committee's terms of reference encompassed wider issues, including the role and composition of boards.

The main recommendations of the Cadbury report were as follows: that the posts of chairman and chief executive should normally be separated and that, where the posts were combined, a senior non-executive director should be designated; that companies should appoint at least three non-executive directors of whom two should be independent; that companies should set up audit, remuneration and nomination committees composed wholly or mainly of non-executive directors; and that there should be a formal process for appointing non-executive directors.<sup>25</sup> A code of good practice was set out, and companies were required to state in their annual reports whether or not they complied with it; if they departed from the code, they had to explain to their shareholders why they did so. The comply-or-explain principle became a central element in the British corporate governance system.

Cadbury's focus on the supervisory role of outside directors was criticised by some businessmen, mainly on the grounds that it would lead to divisions on the board between executive and non-executive members. Sir Owen Green, chairman of BTR, one of the country's most successful engineering groups, argued that a board made up of insiders who had an intimate knowledge of the business and a strong personal commitment to its success was more

likely to be effective than one which contained detached outsiders with no day-to-day involvement in the company and no understanding of its problems. “The fading reality of a unitary board will be further diluted by continuing emphasis on the distinctive roles of non-executives in governance. In that event the introduction, de facto, of the upper tier Teutonic shield of the great and the good will not be long delayed.”<sup>26</sup>

Sir Owen was highlighting a question which would remain at the heart of the corporate governance debate: how could a part-time director, knowing little about the business, contribute in any significant way to its success? However, Sir Owen’s was a minority view. The general reaction to Cadbury among business leaders and investors was favourable, and the report accelerated the changes in corporate governance that the Bank of England had been pressing for. Between 1988 and 1993 the number of listed companies which separated the roles of chairman and chief executive increased from 55 per cent to 75 per cent, and the average proportion of non-executive directors on boards rose from 36 per cent to 41 per cent.<sup>27</sup> The number of companies operating audit committees rose from 35 per cent to almost 90 per cent.

There was also some evidence during this period — not directly linked to the Cadbury report — that non-executive directors were becoming more assertive in situations where the performance of the chief executive was causing concern. A spectacular example was the ousting of BP’s chairman and chief executive, Robert (later Sir Robert) Horton, in 1992. Appointed to the post two years earlier, Horton had strong views about how BP should be modernised, and he was praised by outside commentators in the first year of his chairmanship. However, his management style caused resentment and threatened to destabilise the company, prompting outside directors to conclude that a change at the top was needed. Horton resigned, and, for the first time in BP’s history, the two top posts were separated. One of the non-executive directors, Lord Ashburton, assumed the post of non-executive chairman and David Simon, who had been Horton’s deputy, became chief executive.

Lord Ashburton served as chairman for only three years, but the principle of separating the two posts was maintained. His immediate successor as chairman was David (later Lord) Simon, but when Simon left the company in 1997 to take up a post in the new Labour government he was succeeded by one of the non-executive directors, Peter Sutherland. This reflected a partial shift from the common practice of appointing the retiring chief executive of a company as its chairman. In Courtaulds, for example, when Sir Christopher Hogg gave up the post of chief executive in 1991 he became non-executive chairman, but when he retired in 1996 he was succeeded, not by the chief executive, but by one of the non-executive directors, Sir David Lees.

The most important consequence of the Cadbury report was to enhance the responsibilities and public visibility of non-executive directors, and this was reinforced by the Greenbury committee, which reported in 1995.<sup>28</sup> Set up in response to public concern about the high level of remuneration for top managers — especially in the companies which had been recently transferred from the public to the private sector — Greenbury recommended that remuneration committees should consist entirely of independent directors. Full details of senior executives' remuneration should be set out in a detailed report to the annual general meeting, and the remuneration committee chairman should be prepared to explain the report to shareholders.

Three years after Greenbury another committee was set up under Sir Ronald Hampel, chairman of ICI, to review the changes that had been made since Cadbury and to consolidate the main recommendations into what came to be called the Combined Code.<sup>29</sup> The Hampel report broke no new ground, but it put more emphasis on the need for flexibility. For example, it agreed that the separation of chairman and chief executive “is to be preferred, other things being equal, and [that] companies should justify a decision to combine the roles”, but it was wrong to assume that a combination of the two roles was always undesirable. Hampel made no specific recommendation as to the proportion of non-executive directors on the board, but stated that the number should be large enough to ensure that no individual or group of individu-

als could dominate the board's decision-making. The report also recommended that a majority of the non-executive directors must be seen to be independent — that is, free from any current or past commercial relationship with the company which might affect their judgment.

The Hampel report came at a time when the issue of two-tier boards had again become a topic for discussion, mainly because of moves by the European Commission to harmonise corporate governance rules in member states. There was also a view in academic circles that the exclusive focus on shareholder value was wrong, and that companies should be made responsible to a wider range of stakeholders, perhaps through giving them seats on a supervisory board. In a report issued as the Hampel committee was beginning its work the CBI warned that the unitary board was under attack.<sup>30</sup> “Some argue that companies should be accountable to all stakeholders rather than exclusively to shareholders. Others fear a subtle undermining of the unitary board from the role now placed on non-executive directors by Cadbury and Greenbury.” The CBI declared that the board's two key responsibilities — direction and oversight — were best combined in a single board, “with its collegiate structure, flexibility of perspective and mix of executive and non-executive directors”.

This was endorsed by the Hampel committee which found “virtually no support” for the two-tier structure. It also warned that the higher profile now given to non-executive directors as a result of Cadbury had tended to overemphasise the monitoring role. Non-executive directors, said Hampel, “are normally appointed to the board primarily for their contribution to the development of the company's strategy. This is clearly right. We have found general acceptance that non-executive directors should have both a strategic and a monitoring function ... What matters in every case is that the non-executive directors should command the respect of the executives and should be able to work with them in a cohesive team to further the company's interests.”

Following the publication of the Combined Code the structure of boards continued to evolve in line with the principles set out by

Cadbury and Hampel. By the end of the 1990s the number of large companies that still combined the posts of chairman and chief executive had dwindled (Table 1), and in a growing proportion of cases the chairman was an outsider, not a former employee.

**Table 1: Executive and non-executive chairmen 1990–1998  
based on the largest 460 London Stock Exchange firms\***

Year	Executive chairman	Non-executive chairman	Combined roles
1990	269	105	108
1991	280	106	96
1992	253	133	82
1993	240	150	62
1994	224	176	47
1995	205	189	36
1996	176	211	33
1997	173	207	30
1998	155	207	21

\* The figures are based on the top 460 UK companies listed on the London stock market, ranked by market capitalisation, over the period 1990–1998. The sample is made up of all those companies which figured in the top 300 by market capitalisation at the start of each year. Investment trusts are excluded.

Source: Annita Florou, "Trends and developments in top management teams: evidence from UK panel data", *Corporate Governance*, Vol 2, No 1, 2003

Despite rumblings of dissent from those who shared Sir Owen Green's scepticism, the general view in the business community was that corporate governance in the UK was now on the right track and that, through the comply-or-explain principle, a good balance had been struck between rules and flexibility. The Cadbury report also had a considerable influence outside the UK, with several countries adopting codes which followed the UK model. Even in the US, although there was still a strong attachment to the combined chairman/chief executive role, many companies

appointed the most senior of their outside directors as the lead or presiding director, with functions somewhat similar to those of the independent chairman in the UK. “Lead directors came to play an increasingly important role in US corporate governance practice, providing an organisational focal point for crises where the CEO’s actions have been challenged.”<sup>31</sup>

Britain’s boards had moved a long way since the Bank of England’s initiatives in the early 1970s. But, as the Bank had recognised, an increase in the number of non-executive directors was no guarantee of board effectiveness. Even if boards contained fewer so-called “guinea pigs” than before (see box, below), how easy was it in practice to combine the roles of monitor and team player? Striking the right balance between these roles was not easy, as was shown in what happened at two of Britain’s biggest industrial companies.

GEC in the mid-1990s was one of Britain’s largest and most profitable industrial companies. It had been built up since the mid-1960s by a dominant leader, Lord Weinstock, and its board had played a largely passive role. After Weinstock’s retirement the board was reduced in size, and several new non-executive direc-

### The decline of the guinea pig

“Not long ago, the job of an independent director was a delightful perk for important (and often self-important) business folk at the end of their professional career. Corporate bosses would appoint executive directors of other companies on the principle ‘you scratch my back, I’ll scratch yours’. This type of non-executive director would typically gather a portfolio of companies for his retirement. In Britain these independents were sometimes known as ‘guinea pigs’ — for a guinea and a free lunch they were happy to sleep through any chief executive’s presentation of his corporate plan. The guinea pigs have gone.”

*The Economist*, February 8, 2001



## The GEC/Marconi story

General Electric Company (GEC) was transformed at the end of the 1990s from an industrial conglomerate into a focused telecommunications equipment company; the name of the company was changed to Marconi to emphasise its new vocation. Several businesses were divested, including a highly profitable defence electronics subsidiary, and two large acquisitions were made in the US. When the telecommunications boom collapsed in 2000 and 2001, Marconi found itself in a very difficult financial position. The next few years saw the virtual disappearance of what had been one of the UK's largest and most profitable engineering groups; what was left of the telecommunications business was sold to Ericsson of Sweden in 2005.



tors, including a respected chairman, were appointed. This was a balanced board that conformed with Cadbury, but it did not prevent some poor decisions by the executive management. The biggest mistake, easier to see with hindsight than at the time, was to recast GEC as a telecommunications equipment supplier (the name was changed to Marconi), in the belief that the internet would generate an ever-increasing demand for telecommunications services. When the internet boom collapsed, Marconi found itself in a difficult financial situation, and most of its businesses were later sold (see box, above).

Another rash decision, again easy to criticise with hindsight, was made in 1997 by ICI, which was then Britain's largest chemical company. In an attempt to shift from the commodity end of the chemical industry into less cyclical and higher margin businesses, ICI paid £5bn to acquire Unilever's specialty chemical companies. The price was almost certainly too high, and most of it was to be recouped by the sale of ICI's unwanted commodity businesses. When some of the projected sales fell through ICI found itself in a weak financial position from which it took several years to recover.



Although its performance improved after a change of management in 2003, ICI was taken over by Akzo Nobel in 2007.

Any company can make mistakes, and it is perhaps unfair to regard what happened at GEC and ICI as failures of corporate governance. Yet these episodes underlined the difficulty faced by non-executive directors when presented with ambitious and plausible proposals from a committed and enthusiastic management team; in both cases the strategy, when first announced, was applauded by the stock market. In such circumstances, to force the management to abandon their chosen plan takes courage and self-confidence on the part of the non-executives, who are in any case much less informed about the details of the plan than the executives.

The non-executive directors, as conceived by the Bank of England in the 1970s, constituted one of two safeguards against a company going off the rails. The other protection was to come from the institutional investors. How much progress had there been on this front? Because most of the intervention by institutions took place behind closed doors the extent of shareholder activism during the 1990s is hard to judge. There were some notable cases which did become public, as at Barclays Bank in 1993 when the institutions pressed for a separation of chairman and chief executive. Another was the successful effort by Prudential and other investors to remove Bill Rooney, the chief executive of Spring Ram, a kitchen and bathroom equipment manufacturer which had been highly successful but had expanded too fast. The first approach from investors was rebuffed by Rooney, who had a supportive board behind him, but Prudential, which owned 12 per cent of the company, assembled a sufficiently large group of like-minded shareholders to force Rooney out.

In reviewing this and other instances of investor intervention two American academics concluded that the British system, while not flawless, “works better at effecting managerial changes and making boards of directors sensitive to shareholder desires than do current practices in the US”.<sup>32</sup> Other observers were less complimentary, arguing that the intervention often came after the damage had been done, and when it might be too late for the company to be

restored to health, even under new management. Paul (later Lord) Myners, a leading City practitioner who was commissioned by the government to review the policies of the investing institutions, found “evidence of general reluctance of fund managers to tackle corporate performance in investee companies, particularly pre-emptive action to prevent troubled companies developing serious problems”.<sup>33</sup>

What did happen during the 1990s was that the institutions began to take a closer interest in board appointments. Since the non-executive directors would always be more fully informed than outside investors about what was happening in the company, they were the first line of defence against things going wrong — hence the importance of getting these appointments right. Vigilance on the part of investors was especially necessary in the not uncommon situation in which a long-serving (and successful) boss was reluctant to hand over the reins; the institutions sometimes had to step in to ensure that the transition was properly handled, and that the right successor was put in place.

## The dot.com crash and the banking crisis: a corporate governance failure?

---

*The banking crisis of 2008–09 raised doubts about some aspects of the governance system, especially the independence criteria for appointing chairmen and non-executive directors. The ownership responsibilities of institutional investors also came under closer scrutiny.*



*“Have you noticed how he’s now using the words ‘collective responsibility’ a lot more often.”*

Two spectacular events occurred in the first decade of the new century which highlighted flaws in corporate governance on both sides of the Atlantic. The first was the collapse of the telecoms/dot.com boom in 2001. The second was the banking crisis of 2008–09.

In the US the dot.com collapse exposed irresponsible behaviour in several previously high-flying companies — Enron being the extreme case — and raised questions about the reliability of financial reporting, about the independence of auditing firms, about the role of investors and investment analysts, and about the usefulness of outside directors. The outcome was a tighter regulatory framework embodied in the Sarbanes-Oxley Act, which was designed, among other things, to strengthen the monitoring role of boards of directors. Under the new rules the audit committee had to be composed wholly of independent directors, and independence was defined more narrowly to mean that no member of the committee “may accept any consulting, advising or other compensatory fee from the company or its affiliates or be an affiliated person of the issuer or any subsidiary”. A leading US corporate lawyer has described the relevant section of the Sarbanes-Oxley Act as “a fundamental regime change in corporate governance — now, a federal mandate for independence on the board was unequivocal and set a new baseline for the conduct and monitoring of corporations and their management”.<sup>34</sup>

In the UK, the Enron affair and the regulatory response served to re-emphasise the importance of non-executive directors as monitors of management. This issue was taken up in the next major review of corporate governance, conducted by Sir Derek Higgs, a leading City practitioner.<sup>35</sup> The Higgs review, published in 2003, did not depart in any fundamental way from the principles set out in Cadbury and Hampel, but it strengthened the independence requirement in the Code and introduced some novel elements. It stated unequivocally that the chief executive should not go on to become chairman of the same company, and that the chairman, when appointed, should be independent. This was defined to mean not just that the chairman should not be a former employee, but that he or she “should not hold cross-directorships or significant links with other directors through involvement in other companies or bodies; should not be a significant shareholder; and should not

## ICI falls into line

Up to the early 1990s ICI had a full-time chairman and no separate chief executive. The posts were separated in 1994, after the company had been split into two with the demerger of the pharmaceutical division into Zeneca. Sir Denys Henderson, who had been chairman before the demerger, remained in that post, and Sir Ronald Hampel was made chief executive. When Henderson retired in 1997, Hampel took over as chairman, with Charles Miller Smith (who had joined the company a few years earlier from Unilever) becoming chief executive. Miller Smith became chairman in 1999 and remained in that post until 2002, when he was succeeded by one of the non-executive directors, Lord Trotman, former chairman of Ford. With the board now consisting of five non-executives (including the chairman) and five executives, ICI became fully compliant with the Combined Code.

have served on the board for more than ten years". At least half the board, excluding the chairman, should comprise non-executive directors who satisfied these independence criteria.

Two other issues which had been discussed in earlier reports were reinforced and elaborated by Higgs. One was the requirement that the board should appoint a senior independent director who "should be available to shareholders if they have reason for concern on which contact through the normal channels of chairman or chief executive is inappropriate or [which it] has failed to resolve". The other was the requirement for regular board appraisal. "Every board should continually examine ways to improve its effectiveness. Boards can benefit significantly from formally reviewing both individual and collective board performance, including committees."

There was some anxiety in the business community that Higgs was making the Code too prescriptive, but most companies chose to fall into line with the guidelines (Tables 2 and 3). For example, ICI, which for most of the post-war period had had a full-time chairman and no separate chief executive, appointed its first non-executive chairman in 2002 (see box, above). Unilever, the Anglo-Dutch group which for many years had had a board consisting entirely of

executives, with external advice coming from a group of advisory directors, went through a more radical reorganisation, culminating in 2007 in the appointment of its first independent non-executive chairman; the board in that year contained two executive directors (chief executive and chief financial officer) and eight non-executive directors. Another company which had refused to appoint outside directors was Morrisons, the supermarket group partly controlled by the Morrison family. After the takeover of Safeway in 2004 the chairman, Ken Morrison, came under pressure from shareholders to bring in non-executive directors. By 2007 four outsiders had been appointed and when Ken Morrison retired the company appointed an independent non-executive chairman, Sir Ian Gibson.

The few companies which combined the posts of chairman and chief executive, or which allowed their chief executive to become chairman, generally found themselves under attack from shareholders. When Sir Stuart Rose was made executive chairman of

**Table 2: Average board size and mix of executive and non-executive directors 1995–2005**

	Size	Executive directors	Non-executive directors
1995	9.69	5.20	4.50
2000	9.83	4.77	5.06
2005	9.73	3.92	5.81

Based on FTSE 350 companies, excluding investment trusts and foreign-registered companies

**Table 3: Increase in number of non-executive chairmen**

	Total	Non-executive	%
1995	173	82	47.4
2000	263	169	64.3
2005	313	247	78.9

Source: Geoffrey Owen and Tom Kirchmaier, "The changing role of the chairman", a report to the Chairmen's Forum, 2006

Marks & Spencer in 2008 (taking over from a non-executive chairman, Lord Burns), he was strongly criticised by the institutions. Although the appointment went ahead, Rose stayed in the post for only two years; he was succeeded as chairman in 2010 by Robert Swannell, a merchant banker.

The main arguments for separating the two top posts were that they involved different responsibilities and skills, and that a concentration of power at the top was dangerous. But was there a danger, if the chairman was independent according to the new criteria, that he or she would be too ill-informed about the company to play an effective role? The same question could be asked about non-executive directors: was independence being given too high a priority, as opposed to knowledge of the business?

Some of the large clearing banks, notably HSBC, had chosen not to comply with the rule that the chief executive should not become chairman, arguing that the complexity and risks of the banking industry made it essential for the chairman to be totally informed about the company's affairs. Others took a different view. In 2006 the Royal Bank of Scotland appointed as its non-executive chairman Sir Tom McKillop, formerly chief executive of the pharmaceutical group AstraZeneca. Another non-banker at the head of a major bank was Lord Stevenson at HBOS. Stevenson, who had held a range of board posts in non-financial companies, had taken on the chairmanship of the building society Halifax in 1999, and when that company merged with the Bank of Scotland in 2001 he was made chairman of the enlarged group.

The suitability of these appointments came under scrutiny in the banking crisis which began with the near-collapse of Northern Rock in the autumn of 2007. While the crisis had multiple causes, it became clear that some British banks had been run in a way that exposed them to excessive risks, and that the risks had not been properly evaluated by their boards of directors; a much-cited case was the acquisition of ABN-AMRO, a Dutch bank, by the Royal Bank of Scotland in 2007, a transaction later recognised as mis-conceived and over-ambitious. The fact that several bank chairmen (including the chairman of Northern Rock) and non-executive

directors had little or no direct banking experience was seen as a contributory factor in their inability to control chief executives bent on rapid expansion. A scathing comment came from Lord Myners, who was later appointed Financial Services Secretary in the Treasury. “The typical bank board”, Myners wrote, “resembles a retirement home for the great and the good.”<sup>36</sup>

In the light of these events, the government asked Sir David Walker (whose experience of corporate governance reform went back to his work in the Bank of England in the 1970s and early 1980s) to conduct a review of corporate governance in UK banks and other financial institutions. Sir David’s report, published in November 2009, had two main strands.<sup>37</sup>

The first centred on strengthening the ability of the board, and particularly that of non-executive directors, to monitor the management. The report recommended that at least some of the non-executive members of the board should have “financial industry experience closely relevant to the business of the entity” and that banks should give greater weight to experience in making these appointments. Banks should be “ready to depart from the current independence criteria where they believe this to be appropriate”. It was unsatisfactory that the experience of many bank executives, including chief executives, should be excluded from the industry because they were unable to serve on the boards of the companies from which they had retired. The Walker report suggested that “bank boards where the previous CEO became chairman appear to have performed relatively well both over a longer period and in the recent crisis phase”. The report also recommended that banks should establish a risk committee, separate from the audit committee, made up of a majority of non-executive directors.

The second strand in the report was the recommendation that institutional shareholders should be more willing to engage with the boards of banks and financial institutions. “With hindsight,” the report said, “the board and director shortcomings would have been tackled rather more effectively had there been more vigorous scrutiny by major investors acting as owners.” In order to promote a more productive dialogue between banks and investors Walker



proposed that long-term investors should accept a stewardship obligation, which would involve close attention to the performance of companies over a long- as well as a short-term horizon, continuing assessment of the quality of the senior executives, and “satisfaction to the extent possible that the board and its committees are appropriately composed and function effectively”.

These proposals were directed at financial institutions, and several of them were taken up by the Financial Services Authority; new director appointments, for example, were subjected to much tighter scrutiny by the FSA. But the Walker review also had implications for all listed companies. Some company chairmen had begun to question whether the independence rules were unnecessarily restrictive, depriving them of the services of well-qualified, knowledgeable individuals who would be valuable as board members. A few non-financial companies had chosen to depart from the independence guidelines and had persuaded their shareholders to accept the decision. For example, Tesco in 2004 replaced the retiring independent chairman, John Gardiner, with a long-time Tesco employee, David Reid. Reid had joined Tesco in 1985 as finance director and later held several other executive positions. But Tesco’s performance over the preceding decade had been so outstanding that few shareholders were inclined to question the appointment. Most companies had preferred not to run the risk of a clash with their investors through the appointment of an insider as chairman; in this as in other areas of corporate governance, the inclination was to comply rather than to explain. Now, with the Walker review suggesting that independence had been overstressed, they seemed likely to rethink their policies.

The proposal that institutional investors should accept an enhanced responsibility for stewardship raised a different set of issues. There was some evidence during the 2000s that, at least as far as board appointments were concerned, the institutions were taking a stronger line. One example was their refusal in 2003 to accept Michael Green as chairman of ITV, the company formed by the merger between Carlton Communications and Granada, even though the boards of both merging companies had supported the appointment. In the following year the supermarket group Sains-

bury was forced by shareholders to withdraw the nomination of Sir Ian Prosser as chairman of the company. The institutions were also questioning what they saw as over-generous remuneration arrangements for senior executives. But how much more could realistically be expected of them? How intrusive should their engagement be and how far should they be involved in strategic decisions?

A complicating factor was the change that had taken place over the previous decade in the ownership of listed companies, with hedge funds, short-term traders and a range of non-British investors now holding a larger proportion of the total shares outstanding (Table 4). Thus companies had to deal with a wider variety of investor groups, some of which had little interest in engaging in a continuing dialogue.

Sir David Walker acknowledged in his report that shareholders with short-term horizons were now playing a larger role. However, he argued that “the fact that the shareholder population includes holders such as hedge funds with significant stakes who may be ready to exit the stock over a relatively short time frame increases rather than diminishes the need for those who are naturally longer-term holders to engage proactively where they have areas of concern”. This view was endorsed by the Financial Reporting Council, which after

**Table 4: Ownership of UK equities**

	Individuals	UK Financial Institutions <sup>a</sup>	Foreign	Other <sup>b</sup>
1963	54.0	29.0	7.0	10.0
1975	37.5	47.3	5.6	9.6
1981	28.2	57.6	3.6	10.6
1994	20.3	59.8	16.3	3.6
2000	16.0	47.1	32.4	4.5
2008	10.2	39.9	41.5	8.4

<sup>a</sup> principally insurance companies, pension funds, unit trusts and investment trusts

<sup>b</sup> including charities, private non-financial companies, public sector and banks

Source: Office of National Statistics

the publication of the Walker report introduced a stewardship code for investors, based on the same comply-or-explain principle that applied to non-financial companies under the Combined Code; investors should either sign up to the code or explain why they did not do so. Sir Christopher Hogg, then chairman of the FRC, described the stewardship code as “the first move towards a profound change in the climate of engagement between companies and shareholders.”<sup>38</sup>

There was some scepticism among our interviewees about how effective the stewardship code would be. But what was clear was that in this and other areas the strengths and weaknesses of the British corporate governance system were once again under scrutiny — from politicians, regulators and business leaders.

One issue which concerned the politicians was the dearth of women on boards of directors. In pursuit of a commitment made in the Coalition Agreement the new government asked Lord Davies, former chairman of Standard and Chartered, to investigate how the obstacles to the appointment of women as directors might be reduced. In his report, Lord Davies rejected the imposition of statutory quotas, but recommended a series of steps that would put pressure on companies to appoint more female directors. FTSE 100 companies should aim for a minimum of 25 per cent female representation by 2015 (compared with 12.5 per cent in 2010) and provide regular reports on progress.

To reinforce these targets, Lord Davies proposed that the Financial Reporting Council should amend the Corporate Governance Code to require listed companies to establish a policy on boardroom diversity, including “measurable objectives for implementing the policy”. In the section of the annual report dealing with the work of the nomination committee, companies should disclose how they address diversity in the search and nomination process. Executive search firms should draw up a code of conduct to ensure that gender diversity is given due weight in the criteria relating to board appointments. Lord Davies also suggested that in considering board appointments companies should be more willing to consider women from outside the corporate mainstream. “Although there is a real need for candidates to be financially literate, financial responsibility, just like sector expertise, can be taught and should not be a pre-requisite for appointments.”

If, as expected, these recommendations are implemented, the steering board which advised Lord Davies will remain in existence, and will report annually on how much progress is being made. Lord Davies warned that if the voluntary approach did not achieve significant change “government must reserve the right to introduce more prescriptive alternatives”.

A broader issue which was of particular interest to Vince Cable, Secretary of State for Business, Innovation and Skills in the coalition government, was “short-termism”. In Cable’s view, and that of some other observers, there were too many cases where investors and boards of directors focused too narrowly on short-term movements in the share price at the expense of long-term investment in the development of the business. Several recent takeovers, notably the acquisition of Cadbury by Kraft of the US, had raised the question of whether investors in UK companies were too ready to sell out when offered a high price for their shares, without sufficient consideration for the long-term viability of the company as an independent enterprise. In October 2010 the government launched a consultation exercise — entitled “A long-term focus for corporate Britain” — designed to elicit views on “whether the system in which our companies and their shareholders interact promotes long-term growth or undermines it”.<sup>39</sup> The consultation ended in January 2011 and the government was due to give its response by April.

Did this activity on the part of the government imply that the corporate governance system as a whole would be subjected to another thoroughgoing review? In June 2010 the Financial Reporting Council responded to the banking crisis by producing a revised version of the Combined Code, now known as the Corporate Governance Code. The new document clarified and sharpened some of the earlier provisions, and introduced some new elements, including the requirement that directors should submit themselves to annual re-election by shareholders and that boards should undertake an external evaluation of their performance every three years. To judge by the comments made to us by current chairmen, the view in the business community was that further changes in the system were not needed and that there should be a moratorium on corporate governance inquiries.

## Where are we now?

---

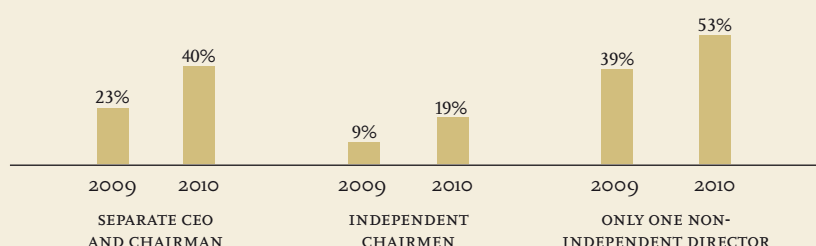
*Most business leaders agree that the corporate governance reforms that started with Cadbury have been beneficial, but there are worries about how some aspects of the system are working, and about the possibility of further reforms which might prove counter-productive.*



*“What bothers me is that we all look so successful.”*

## More US companies are splitting the roles of chairman and chief executive

The Spencer Stuart Board Index 2010 for the US shows a continuing shift towards independent board leadership, with 40 per cent of boards now splitting the CEO and chairman roles, up from 23 per cent a year earlier. Although many of these chairmen are former chief executives of the company concerned, 19 per cent are truly independent, versus just 9 per cent in 2009. The Spencer Stuart survey also showed that 53 per cent of boards — a new high — have only one non-independent director, the CEO; this has risen from 39 per cent in 2009 and 39 per cent in 2005.



When asked for their reflections on the impact of corporate governance reform since Cadbury, our interviewees felt that on balance the changes had been beneficial. “There is greater accountability, greater transparency, a better flow of information to the non-executives,” one chairman said; “the audit function has got a lot stronger, which is good.” At the same time there was a frank recognition that some of the boards on which they had served had performed poorly, and a degree of anxiety about how some elements of the corporate governance system were working.

On the details of the system, most agreed that the UK had been right to go for the separation of chairman and chief executive, and that in this respect the British system was better than that of the US. The number of US companies which separate the two posts has been increasing in recent years (see box, above), but even

when the posts are separated the typical American chairman has less power, relative to the chief executive, than his or her British counterpart. Some leading American corporate governance experts remain doubtful about the merits of the British system.<sup>40</sup> Yet the dominant view in the British business community is that too much concentration of power at the top is dangerous, and that this cannot simply be offset by the US practice of appointing a lead or presiding director.

“You’ve got to have a chairman whose job is to hire and fire the chief executive,” one of our interviewees said. Another recalled how lonely he felt when he served both as chairman and chief executive. “You end up talking to yourself and that is not a very healthy position. You think you have lots of friends but actually you haven’t.” In 2010, according to the Spencer Stuart UK Board Index, more than 90 per cent of the top 150 companies had a separate, part-time chairman, up from two-thirds ten years earlier.

On the size of boards, the preference was for around ten to twelve members; a board larger than fifteen was thought to be hard to manage (Table 5). But on this, as on other aspects of the corporate governance system, there was no case for hard-and-fast rules. “There is no magic about the size of boards,” one chairman said; “whether a board is dysfunctional or not has very little to do with how many members it has.”

**Table 5: Size of boards in 2010 (largest 150 FTSE companies)**

8 or fewer	9–11	12–14	15 or more
27.3%	50.7%	18.0%	4.0%

Source: Spencer Stuart 2010 UK Board Index

On board size chairmen can agree to differ, and the same applies to the balance between executives and non-executives, on which there is much less consensus. Some argue that the presence of senior line or functional managers on the board, in addition to the chief executive and chief financial officer, is unhelpful. “These people cannot bifurcate themselves into an independent analytical director who owes his responsibilities to the shareholders while at the same time explaining themselves and the job they do for the CEO sitting next to them.” Others are no less insistent that a balanced board — say five executives in a board of twelve — has the great advantage of giving the outside directors “a flavour of what’s happening on the operational side of the business”. One commented that it was a proper aspiration for young executives to aspire to become board members — “it is one of the biggest career moves they will ever make” — and to exclude anyone other than the CEO and the CFO is far too restrictive. It was also pointed out that the trend towards fewer executives on boards (and towards smaller boards) reduced the supply of potential non-executive directors who could serve on the boards of other companies. One of our interviewees commented that, as a new director in his own company, he found serving as a non-executive director in another company a valuable learning experience.

As for the non-executive component, most of our interviewees like to have at least one director who is a serving executive in another company, preferably as CEO or CFO. “It’s absolutely essential that every board should have one such person,” one said; “it ensures that there is someone on the board who faces the same challenges as our own CEO and can bring his or her experience to bear — and it also helps to keep the average age down.” The problem here is one of availability. CEOs and CFOs in large companies are increasingly reluctant to take on non-executive directorships. In 2010 only 41 per cent of the CEOs in the top FTSE companies held a non-executive directorship. The larger the company, the less likely is the CEO to take an outside board post, and the same is true of chief financial officers. A serving CFO is an obvious candidate to be chairman of another company’s audit committee, but the time commitment in that post is now so great that few CFOs are prepared to take it on.



Hence companies have to rely mainly on people who have retired from their full-time jobs. Many of them can be described as professional non-executive directors, holding perhaps three or four board seats. The favoured candidates will have served as senior executives, preferably in the recent past and preferably in more than one company, so that they have acquired experience in a range of different situations.

How many board seats should the professional non-executive take on? There has been a substantial increase in the time commitment and the weight of responsibility now attached to these posts, especially for the committee chairmen and for the senior non-executive director, and this is tending to rule out multiple directorships. "I'd like to see non-executives taking on fewer posts and being paid more," one chairman told us; "I'd prefer them to take three posts paying £75,000 a year rather than five at £40,000."

The internationalisation of British business is reflected in a rise in the proportion of foreign directors, from 10 per cent at the end of the 1990s to about 30 per cent today. That figure compares rather starkly with the small proportion of female directors, who account for only 12.5 per cent of board members in FTSE 100 companies. Almost all our interviewees agreed that boards should desirably have a minimum of two female members, but there was no support for Norwegian-style quotas. Increasing the pool of suitable candidates would depend in large part on removing any obstacles to the promotion of women to senior positions below the board; in 2010 women represented only 5.5 per cent of executive directors in FTSE 100 companies.

Most of our interviewees were supportive, with varying degrees of enthusiasm, of the enhanced role of the senior independent director, or SID. "A useful backstop and safety valve," one chairman said, "although I much prefer anyone who is uneasy to see me directly." Others were not certain whether the SID carried enough weight to deliver an uncomfortable message to a powerful chairman. On board evaluation, views were mixed, with one saying it was the best thing to have come out of Higgs, while others found the exercise rather stilted "too much box ticking, and not very relevant to the

actual dynamics of how the board operates". A common view was that it was better to have board appraisals than not to have them, and that it was worth persevering with them.

Taken as a whole, the corporate governance framework now in place was seen as workable and generally helpful. Yet there were also some reservations and anxieties, which are summarised below.

### THE CHAIRMAN/CEO RELATIONSHIP

There are still too many dysfunctional boards, and the most common cause is the inability of the chairman to establish a good working relationship with the chief executive. This can arise for a variety of reasons. A newly appointed chairman may be taking on the job soon after serving as chief executive in another company, and this can be a difficult transition, needing more preparation and training than is usually provided. Much depends on the chairman's previous experience; moving into the role for the first time is likely to be easier for someone who has been chief executive in a diversified group, supervising several divisional managers, than for someone who has been in a less complex, single-industry business.

"For the split structure to work the chairman must exercise some degree of self-restraint, which can be difficult for someone with so much power, particularly when he has strong views, a persistent taste for the limelight and recent experience as a successful CEO."<sup>4</sup> This may be why some companies have appointed ex-CFOs as their chairmen rather than ex-CEOs.

The dilemma which all chairmen face is how much or how little to intervene. At one extreme is the chairman who, perhaps for personality reasons or because he or she has insufficient knowledge of the business, is unable to stand up to a dominant chief executive. "If you are ignorant", one of our interviewees commented, "you can end up being a puppet." At the other is the chairman who is so expert in the relevant industry that he or she is tempted to second-guess the executive team. "It is a very tricky balance," one experienced non-executive director told us, "the chairman has to be close to the chief executive while every now and then making it quite

clear to the board that he is sceptical about a proposal. You trust him when he sides with the CEO but you know it will not always happen.”

It is hard to predict in advance how someone new to the chairman’s role will perform. “Ideally you want a dynamic CEO and a wiser, more prudent chairman, but whether you get that combination is pretty fortuitous — it does not happen in many cases. The single most important thing is that the chairman has the interests of the company at heart and not other interests — not political interests, not personal interests over and above that.” The chairman needs to be qualified by ability and experience to run the company in an emergency, if for some reason the chief executive is unable to do the job and no successor is yet in place. “Chairmen are having to work a lot harder, and sometimes they have to take on, as in the BP case, the requirement to be the face of the company, dealing with external stakeholders as well as shareholders.”

A perhaps unintended consequence of the corporate governance reforms that followed the Cadbury report is that the post of independent chairman in the British system has become more important and more demanding (as well as more highly paid). Too many people have been appointed to the job who lack the necessary capabilities to do it effectively. Those capabilities (usefully set out in the Walker review<sup>42</sup>) are partly innate, such as stamina, courage and self-confidence, and partly learnable, including empathy, promoting openness, listening to all points of view, reaching conclusions without appearing to dominate and building confidence in colleagues. Good chairmen will always be hard to find, but better preparation and more emphasis on the learnable parts of the job will make it more likely that the board will function well.

## INDEPENDENCE

There was strong support among our interviewees for Sir David Walker’s comment in his review that, in appointing chairmen and non-executive directors, banks may have overstressed independence to the detriment of relevant knowledge and expertise. “There have been too many people on bank boards”, one interviewee told

us, “who were not financially up to speed — they were very distinguished, very intelligent people, but the world is more professional than that.”

An over-strict definition of independence has the effect of depriving the company of individuals who could make a valuable contribution. “To lose a long-serving director because he is supposed to be no longer independent”, one chairman remarked, “is preposterous. I like people in complex organisations who have been around a long time. It usually takes five years before they become really valuable; to lose them after they have done nine makes no sense.” There is a trade-off between independence and knowledge. “The private equity world has gone for knowledge, the listed company goes for independence — that is one of the biggest differences between the two.”

Not all board members need to be industry experts — the danger then is that the board will suffer from “groupthink” — but “you need one or two people on the board who have the specialist domain knowledge to drill down into the heartland of the business”. There are cases, one chairman told us, where a director might have a possible conflict of interest because his or her company is operating in a related sector, but such conflicts are manageable, and should not be a bar to board membership.

Knowing the industry is no guarantee that the person concerned will be an effective director. Independence in a board context depends at least as much on mindset and personality as on detailed industry expertise. If the director is not ready to question and when necessary to challenge the executive on strategic issues, he or she may bring little value to the board. Nevertheless, relevant experience among the non-executive directors is essential. It is wrong to rule out potentially useful board members because they do not meet an over-rigid definition of independence.

## PROCESS VERSUS SUBSTANCE

Asked what had changed for the worse since Cadbury, one chairman replied: “An over-emphasis on corporate governance.” His view is that some boards have allowed themselves to be too dominated by compliance issues, with the result that too little of their time is devoted to the real business of the company. “One board that I served on started the meeting at 8am and we didn’t get to the real meat of the business until noon — it was process gone mad. Not only were the priorities all wrong, but the effect was to make the meetings extremely boring; a good board has to be one which you enjoy going to.”

Some of the compliance burden can be handled through an efficient company secretary, who can make a big difference to the way a board runs. “A great company secretary can transform the chairman’s life,” one interviewee told us. However, another warned that some secretaries, ever-conscious of the company’s obligations under the Code, were too inclined to push the board to fall in line with the guidelines, even when there was a good case for explaining rather than complying.



*“Send it back to committee — oh — this is committee.”*

This is part of a wider anxiety, that boards are becoming too institutionalised. “You can spend all your time trying to prevent accidents or you can remember that your job is to create value.” More ambitious executives will drift into private equity, and “we will see the gradual death of the plc”. Another worry is that potentially valuable non-executive directors are reluctant to take on posts which they see as too heavily weighted towards compliance, and too dominated by topics that are not central to the company’s future.

A common complaint is that annual reports have become far too long — well over a hundred pages for larger companies.<sup>43</sup> The remuneration report is a particular source of concern. “Remuneration policies have never broken a company but I know a lot of managements that have; you ought to be able to explain your remuneration policy in one and a half pages.” Another suggested that the volume of reporting was so enormous that transparency had been lost. “People can hide behind the quantity of reporting — boards need to get to the point more quickly.”

Several of our interviewees pleaded for a moratorium on new corporate governance rules. “Everybody is scouting around thinking of things to do — it is a process in search of a problem, and I don’t think the problem has been properly defined.”

### COLLEAGUES OR POLICEMEN?

The banking crisis showed that, in some banks, non-executive directors were unable or unwilling to restrain the executives from pursuing excessively risky policies. The same phenomenon has been seen in non-financial companies, as in the GEC/Marconi story referred to earlier. These events have raised once again the long-standing question about the British unitary board: how can non-executives combine the roles of monitor and colleague, and what should the balance be between them?

One of our interviewees thought the UK had arrived at a supervisory board system without acknowledging it. The unitary board is doomed, we were told, mainly because the responsibilities of the outside directors have become so onerous, and so different from

## Walker on two-tier boards

“In practice, two-tier structures do not appear to assure members of the supervisory board of access to the quality and timeliness of management information flow that would generally be regarded as essential for non-executives on a unitary board. Moreover, since, in a two-tier structure, members of the supervisory and executive boards meet separately and do not share the same responsibilities, the two-tier model would not provide opportunity for the interactive exchange of views between executives and NEDs, drawing on and pooling their respective experience and capabilities in the way that takes place in a well-functioning unitary board.”

From section 2.6 of the Walker review, November 2009

what is expected of the executives on the board. The difference is made all the greater by the practice, followed by many companies, of having all the non-executives sit on the main board committees.

Despite these changes, however, the dominant view in the business community, reinforced by the Walker review (see box, above), is that the two-tier structure has more disadvantages than advantages, and that the ambiguity in the position of the British non-executive director on the unitary board is not only workable, but positively beneficial. One chairman said the balance should be “20 per cent policeman and 80 per cent part of the team”, and this probably reflects how most non-executive directors see themselves.

Yet there remains some doubt over the willingness of non-executive directors to make an effective challenge to the executive team when it is necessary to do so. There are strong social pressures towards collegiality. Non-executive directors often form close bonds with their executive colleagues and do not much relish the prospect of outright disagreement, still less confrontation. There is also the question of incentives. How much do they lose if the company gets into trouble? Since outside directors rarely have a large financial

stake in the company the principal risk of failure is damage to their reputation, and it is not clear how powerful an incentive that is.

In circumstances where non-executives find themselves unable to bring about the changes they think are needed — perhaps a weak chairman and a group of directors who are beholden to him or her — they may prefer to resign. There is an element of chance in these situations — whether one of the non-executives has the energy and determination to insist on change in the face of resistance from the chairman and only lukewarm support from other board members. One chairman recalled a case where it was clear that the chief executive had to be replaced but “my fellow non-executives did not have the guts to do it, so I resigned without making a song and dance about it”. Such resignations often take place at the end of the director’s three-year term, and are not much noticed in the outside world.

Here, as in most other aspects of board performance, the key responsibility is that of the chairman. He or she has to ensure that the non-executive directors are independent-minded people willing to speak their mind, and must be sensitive to anxieties that may not be expressed openly in board meetings.

## SHAREHOLDER FRAGMENTATION

The fragmentation of the shareholder base has made investor relations more difficult. As one chairman put it: “A good board listens a lot to what the shareholders say and what they think, but does not necessarily do what any one of them wants. They can’t do what each of them wants because they don’t all want the same thing, so you have to listen carefully and then make up your own mind and do it, and you go sell it to the shareholders.” Another commented: “Some of them want us to buy back shares, some want us to increase the dividend, some don’t want a dividend, some say make acquisitions, some say don’t make acquisitions. The owners of your business are completely dysfunctional.”



Another made the point even more strongly: “The idea of aligning the board’s interests with those of the shareholders is out of the window. Most shareholders have nothing to teach us, nothing to offer us. The stock market is nothing to do with building businesses any more. We’ll let them go and play with themselves. You can’t look to the shareholder interest as an analogue for long-term value creation.”

This, of course, is only one side of the story. There have been cases where the chairman of a poorly performing company has refused to meet with institutional investors who were concerned about its direction, and this obstinacy contributed to that company’s subsequent failure. This is one of the reasons why some institutional investors favour annual elections for chairmen and other directors. As one fund manager told us, “A bad chairman can do a great deal of damage in a year.”

“My goal”, one chairman told us, “is to look after the long-term interests of the company as a whole and to create shareholder value within that. I prefer the word create rather than maximise because maximising shareholder value is a static concept. If an activist shareholder comes along and buys 15 per cent of the equity he may have four times as much as anyone else but he is not going to be over-influential with that 15 per cent. He may have views that are bad for the company and the other 85 per cent won’t like it.”

Several of our interviewees spoke of a lack of trust on the part of investors in how boards were running their affairs, and this had led to rules and guidelines which limited the board’s freedom of manoeuvre. On remuneration, for example: “I’d like the freedom to pay my CEO more in bad times but you can’t do that any more. Because investors don’t trust us to handle remuneration correctly they tie us down with process.” There are also complaints about the disconnect in fund management firms between the people who decide on buying and selling shares and the people whose concern is with corporate governance and corporate social responsibility.

“Fund managers have short-term interests, the governance/compliance experts have long-term interests. Unless you can enlist the right kind of attitudes in institutional investors, comply-or-explain will disappear.”

Some of our interviewees are dubious about the stewardship code introduced by the Financial Reporting Council, partly on the grounds that long-term investors already have the powers they need to intervene in companies that are causing concern, and it is not clear how the code will make their intervention more frequent or more effective. If the stewardship code has the effect of building a greater degree of mutual understanding and trust between long-term investors and boards of directors, that would be welcome, but business leaders will take some convincing that greater engagement by shareholders will happen, and that, if it does, it will produce better-performing companies.

## Conclusion

---

*There is no case for radical changes in the UK corporate governance system, but if there is to be progress towards more well-functioning boards and fewer dysfunctional ones a higher priority must be given to preparing the incoming company chairman for a role which has a special importance in the British system.*



*“No! What kind of an answer is that?”*

Two key elements in any corporate governance system are, first, the role and composition of the board of directors, and, second, the relationship between the board and the company's shareholders. The two are intimately connected, since shareholders have a vital interest in what sort of people are appointed to the board and in how well they fulfil their responsibilities.

For a mixture of historical and cultural reasons, countries differ in their corporate governance arrangements. Whereas Germany has a two-tier structure, with employees represented on the supervisory board, the UK and the US remain wedded to the unitary board. But there are also differences between the British and American systems. In the US the last fifty years have seen an almost complete transition from the advisory to the monitoring board, containing at most two and often only one executive director. Most British boards have a balance of executive and non-executive directors, although the trend has been in an American direction and this seems likely to continue. The UK also relies more than the US on voluntary compliance with corporate governance guidelines, rather than on statute.

Which system is best? There is no clear evidence that the post-Cadbury reforms, while they may have reduced the incidence of Maxwell-type scandals, have given British companies a competitive advantage. German industrial companies are not obviously less successful in world markets because of their two-tier board structure, nor do US companies suffer because the posts of chairman and chief executive are generally combined. Academic researchers have had great difficulty in establishing a link between board structure and corporate performance, a finding which suggests that the impact of governance reforms — for example, an increase in the number of independent directors — on the wider economy should not be exaggerated. The same applies to non-executive directors; they are not running the company, and cannot be blamed for everything that goes wrong.

Corporate governance guidelines are helpful to the extent that they push companies towards good practice and steer them away

## Independence and effectiveness: a US view

“There is no single model of the ‘effective corporate board’. The proper balance between the paradigms of the board as manager versus monitor will differ depending on a number of company-specific characteristics. These include the industry, size, history, shareholder base, and stage of the company in its corporate life. There are companies with conscientious inside directors and chairmen that have served their shareholders’ interests extremely well. Conversely, as some of the recent corporate scandals demonstrate, there are many boards that had the independence characteristics currently in vogue, but failed their shareholders miserably. The mere fact that a company’s board appears less independent than other boards does not necessarily mean that it cries out for a regulatory fix.”

Cynthia A. Glassman  
Commissioner, Securities and Exchange Commission  
February 20, 2004

from board structures and other arrangements which experience has shown to be potentially harmful. But there are dangers in a corporate governance “industry” which takes on a life of its own and leads to ever more prescriptive codes and requirements. There is no single model of an effective board and companies need to be free to choose the structure that fits their particular circumstances (see box, above). A comment contained in the Walker report is relevant in this context: “Boards and board behaviour cannot be regulated or managed through organisational structures and controls alone; rather behaviour is developed over time as a result of responding to existing and anticipated situations.”<sup>44</sup> There is no case for radical changes in the British corporate governance system, although some of the rules should be made more flexible. The challenge now is to make the existing system work better. This means less emphasis on process and more on people and how they behave, less on rules and guidelines and more on the internal dynamics of the board, on identifying men and women with the right characteristics to fill board positions and training them well.

If there is to be progress towards more well-functioning boards and fewer dysfunctional ones, a higher priority must be given to preparing the incoming company chairman for a role which has a special importance in the British system — part-time in most companies but no longer accurately described as non-executive, and more crucial to board effectiveness than was envisaged at the time of the Cadbury report.

# Glossary

---

**Institutional Shareholders Committee:** formed in 1973 as a coordinating body for the institutional investor associations: Association of British Insurers; Institutional Fund Managers Association; National Association of Pension Funds; Association of Unit Trusts and Investment Funds; Association of Investment Trust Companies; British Merchant Banking and Securities Houses Association

**The Bullock Report:** report of a committee of inquiry led by Lord Bullock into industrial democracy (1977)

**PRO NED:** set up in 1981 by the Bank of England, the English and Scottish banks, the Stock Exchange and other City institutions to promote the wider use of non-executive directors; sold to Egon Zehnder in 1994

**Financial Reporting Council:** set up by the government in 1990 to promote good financial reporting through the Accounting Standards Board and the Financial Reporting Review Panel; role extended in 2004 to become the single independent regulator of the accountancy and auditing profession as well as being responsible for issuing accounting standards and dealing with their enforcement

**The Cadbury Report:** report of a committee led by Sir Adrian Cadbury on the financial aspects of corporate governance (1992)

**The Greenbury Report:** report of a committee led by Sir Richard Greenbury on directors' remuneration (1995)

**The Hampel Report:** report of a committee led by Sir Ronald Hampel on corporate governance (1998)

**Combined Code:** a set of corporate governance guidelines first published in 1998 and attached to the Stock Exchange's listing rules; revised in 2003 and 2008 and replaced by the Corporate Governance Code in 2010

**The Higgs Review:** review by Sir Derek Higgs of the role and effectiveness of non-executive directors (2003)

**The Myners Report:** review by Paul Myners on institutional investment in the United Kingdom (2001)

**The Walker Review:** review by Sir David Walker of corporate governance in banks and other financial industry entities (2009)

**The Davies Report:** review by Lord Davies of Abersoch on women on boards (2011)



## About Spencer Stuart

---

Spencer Stuart is one of the world's leading executive search consulting firms. Privately held since 1956, Spencer Stuart applies its extensive knowledge of industries, functions and talent to advise select clients — ranging from major multinationals to emerging companies to nonprofit organisations — and address their leadership requirements. Through 51 offices in 27 countries and a broad range of practice groups, Spencer Stuart consultants focus on senior-level executive search, board director appointments, succession planning and in-depth senior executive management assessments.

For the past 20 years, our Board Services Practice has helped boards around the world identify and recruit independent directors and provided advice to chairmen, chief executive officers and nominating committees on important governance issues.

We lead the highly acclaimed Directors' Forum in partnership with London Business School and Wharton. This programme highlights best practice in the UK's boardrooms through a sophisticated role play involving senior players from FTSE 100 boards, together with top advisers, including Brunswick, Citigroup, J.P. Morgan Cazenove, KPMG, Linklaters, McKinsey and Towers Watson.

We also publish a wide range of articles and publications on boards and governance issues, including the annual *Spencer Stuart Board Index* and the *Spencer Stuart Governance Lexicon*, a guide to the laws, requirements and guidelines governing the role of the non-executive director in 19 key markets. For more information, visit [www.spencerstuart.com](http://www.spencerstuart.com).

## Endnotes

---

1. Ronald Edwards and Harry Townsend, *Business enterprise: its growth and organisation*, Macmillan, 1958, p. 221
2. Jeffrey N. Gordon, "The rise of independent directors in the United States 1950–2005: of shareholder value and stock market prices", *Stanford Law Review*, No 59, 2006–07, p. 1511
3. Harold Evans, *Vickers against the odds 1956/77*, Hodder and Stoughton, 1978, pp. 159–169
4. Evans, *Vickers against the odds*, p. 167
5. R.E.Pahl and J.Winkler, "The economic elite: theory and practice", in Philip Stanworth and Anthony Giddens (eds), *Elites and power in British society*, Cambridge, 1978.
6. "The responsibilities of the British public company", Confederation of British Industry, September 19, 1973
7. Lord Benson, *Accounting for life*, Kogan Page, 1989, p. 164
8. Gordon Richardson, "The joint stock company: adapting to change", Speech to Institute of Directors, November 28, 1978
9. "The conduct of company directors", Department of Trade, HMSO November 1977 Cmd 7037
10. Gordon, "The rise of independent directors in the US", p. 1515
11. Paul Collier, "The rise of the audit committee in UK quoted companies: a curious phenomenon?", *Accounting, Business and Financial History*, Vol 6 No 2, 1996
12. "The composition of company boards", Bank of England *Quarterly Bulletin*, Vol 19 No 4, December 1979
13. R.I.Tricker, *The independent director: a study of the non-executive director and of the audit committee*, Deloitte Haskins & Sells, 1978, p. 34

14. Tricker, *The independent director*, p. 28
15. "London and County Securities Group Ltd", Report by Department of Trade Inspectors, HMSO 1976
16. "Lonrho Ltd", Report by Department of Trade Inspectors, HMSO 1976
17. Jonathan Charkham, "The Bank and corporate governance: past, present and future", Bank of England *Quarterly Bulletin*, Vol 33 No 3, August 1993
18. PRO NED continued to operate, increasingly as a source of information about potential non-executive directors, until the early 1990s. It was sold to the executive search firm Egon Zehnder in 1994
19. "The boards of quoted companies", Bank of England *Quarterly Bulletin*, June 1985
20. "The boards of quoted companies", Bank of England *Quarterly Bulletin*, May 1988
21. Bengt Holmstrom and Steven N. Kaplan, "Corporate governance and merger activity in the US: making sense of the 1980s and 1990s", National Bureau of Economic Research, Working paper 8220, April 2001
22. Gordon, "The rise of independent directors in the US", p. 1520
23. Jay W. Lorsch, *Pawns or potentates, the reality of America's corporate boards*, Harvard Business School Press, 1989, pp. 184–5
24. Bernard S. Black and John C. Coffee, "Hail Britannia? Institutional investor behavior under limited regulation", *Michigan Law Review*, Vol 92 No 7, June 1994
25. "Report of the committee on the financial aspects of corporate governance", the Cadbury report, 1992
26. Sir Owen Green, "Corporate governance — great expectations", Pall Mall lecture delivered to the Institute of Directors, February 24, 1994

27. Martin J. Conyon, "Corporate governance changes in UK companies between 1988 and 1993", *Corporate Governance*, Vol 2 No 2, April 1994
28. "Directors' remuneration", the Greenbury report, 1995
29. "Committee on corporate governance, final report", the Hampel report, January 1998
30. "Boards without tiers, a CBI contribution to the debate", Confederation of British Industry, October 1996
31. Gordon, "The rise of independent directors in the US", p. 1495
32. Black and Coffee, "Hail Britannia?"
33. "Institutional investment in the UK: a review", the Myners report, March 2001
34. Martin Lipton, "The future of the board of directors", March 5, 2010
35. Derek Higgs, "Review of the role and effectiveness of non-executive directors", Department of Trade and Industry, January 2003
36. *Financial Times*, April 24, 2008
37. "A review of corporate governance in UK banks and other financial industry entities", the Walker review, November 2009
38. *Financial Times*, July 28, 2010. By the end of 2010 a total of 130 institutions had published statements of support for the code, including twenty-five of the top thirty investors in UK equities.
39. Department for Business Innovation and Skills, "A long-term focus for corporate Britain", October 2010
40. Colin B. Carter and Jay W. Lorsch, *Back to the drawing board, designing corporate boards for a complex world*, Harvard Business School Press, 2004, pp. 98–106
41. Jay W. Lorsch and Andy Zelleke, "Should the CEO be the chairman?", *MIT Sloan Management Review*, Vol 46 No 2, Winter 2005
42. The Walker Review, Annex 4, "Psychological and behavioural elements in board performance"

43. The average length of a FTSE 350 annual report in 2010 was 128 pages, ranging between 48 and 500. Grant Thornton, “Evolving with the Code”, *Corporate Governance Review*, December 2010
44. The Walker Review, Annex 4

## Cartoon credits

---

pp. 7, 33, 36, 39, 49, 73: courtesy of [www.businesscartoons.co.uk](http://www.businesscartoons.co.uk)

“Alex” (pp. 9, 18) reproduced by permission of Charles Peattie and Russell Taylor, [www.alexcartoon.com](http://www.alexcartoon.com).

pp. 17, 27: From the The Wall Street Journal, permission Cartoon Features Syndicate.

pp. 10, 13, 59, 67: courtesy of [www.CartoonStock.com](http://www.CartoonStock.com)

p. 21: © Peter Arno/The New Yorker Collection/  
[www.cartoonbank.com](http://www.cartoonbank.com)

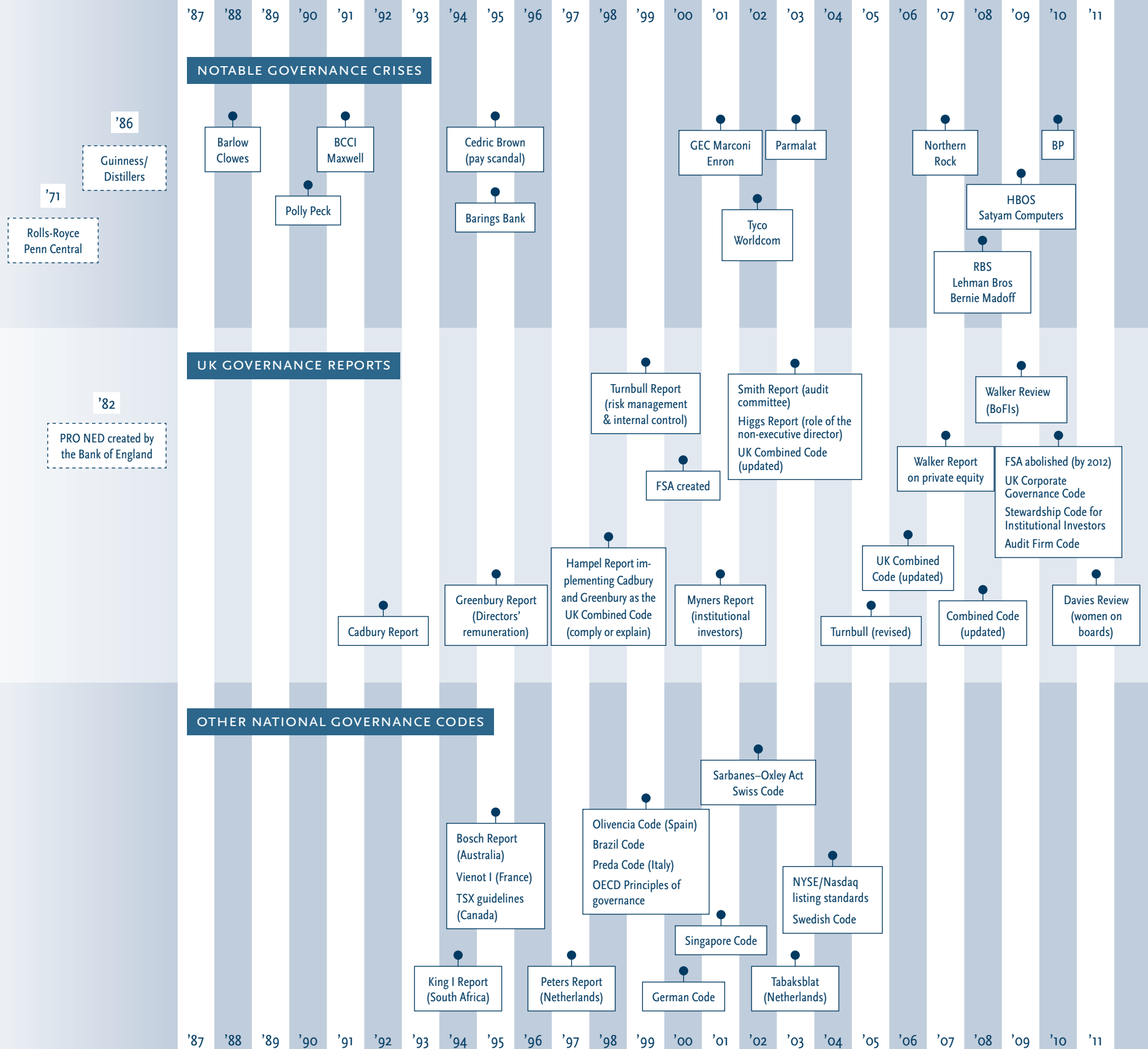
p. 23: © Joseph Mirachi/The New Yorker Collection/  
[www.cartoonbank.com](http://www.cartoonbank.com)

p. 84: courtesy of Punch Limited



*Do you think the directors ever pretend to be us?*

HECTOR BREEZE, PUNCH 1971



The governance of Britain's listed companies has gone through profound changes in the last fifty years. The composition of the board of directors, the role of the chairman, the relationship between directors and shareholders — these and other elements in the corporate governance system look very different today from the arrangements which prevailed in the 1960s and 1970s.

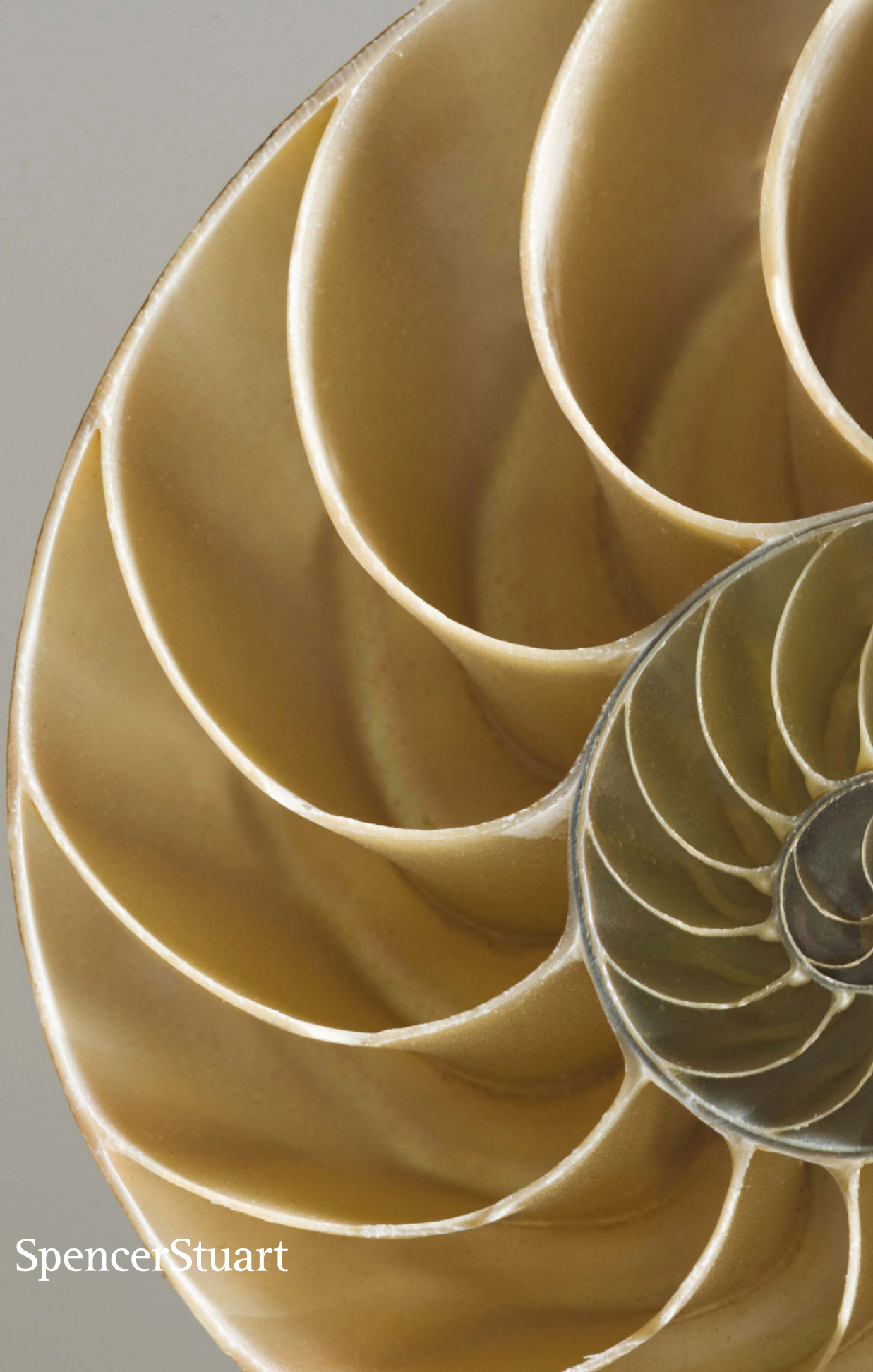
In this book, published fifty years after Spencer Stuart opened its first office in London, Sir Geoffrey Owen traces the development of boards from 1960 to the present day, always in the context of the changing business environment.

Today's boards of directors face a different set of challenges from the ones their predecessors had to deal with. We consider how well equipped they are to meet these challenges, and whether the crescendo of corporate governance reforms have helped them to do so.

©2011 Spencer Stuart. All rights reserved.

For information about copying, distributing and displaying this work, contact [permissions@spencerstuart.com](mailto:permissions@spencerstuart.com).





SpencerStuart