Corporate Governance after the financial crisis: The role of shareholders in monitoring the activities of the board

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Abstract

The 2008 global financial crisis resulted in the downfall of many high profile companies, with many critics accusing the institutional investors in particular of failing to monitor their investments adequately. This article will commence by discussing the foundations of UK corporate governance in order to get an idea of why investor activism was lacking in some instances. Next, the article will discuss the developments that have come about since the 2008 crisis in an attempt to solve this problem. Finally, it will conclude by analysing these developments, and whether further improvements are required.

1. Introduction

Corporate governance relates to the way in which a company is managed, and it ‘...deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.’

Its considerable importance was made clear during the 2008 global financial crisis. In the United Kingdom especially, the high profile demise of big corporate players such as Northern Rock served to highlight the fact that there were severe deficiencies in the way in which some companies were being governed. Indeed, it was not long until the public starting asking questions of the directors of some of these failing companies, many of whom were being rewarded with large pay packages. In 2009, on average, a director’s salary in the UK’s biggest corporations was 81 times greater than that of the average full time worker. This represented a 47-fold increase since 2000. It is clear why statistics such as these resulted in public outcry, because there were many instances where pay appeared unrelated to performance.

It is however, easy to blame the board. Questions should also be asked of corporate entities’ shareholders, and in particular, their institutional investors, who have garnered a reputation for being apathetic. Such investors include pension funds and insurance companies, who will typically have a portfolio of investments but who too often exhibit a degree of passivity when they should in fact be asking

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probing questions and holding company managers to account. Moreover fund managers, who make the investment decisions, can also carry out governance and monitoring activities, but again appear generally not to adequately perform this job. The reasons for this will also be analysed herein. Lord Myners has described such shareholders as ‘absentee landlords,’ an illustration perhaps of the fact that many do not exercise rights such as voting rights, or responsibilities such as attending meetings. This results in ‘ownerless corporation[s].’ Sir David Walker highlights the importance of investor activism, noting that if this had been exercised to a greater degree in the UK banking sector, director behaviour would have been more efficiently dealt with. In view of such criticisms, there has been widespread reform in UK corporate governance. One reform objective has been to encourage shareholders, particularly institutional investors, to monitor companies they have invested in more closely. This article focuses principally on the role of institutional investors; hereafter the term ‘investor’ refers principally to them.

This article will commence by outlining the modern foundations of UK corporate governance, and the associated agency problem. Many soft law developments have been forthcoming that attempt to solve this dilemma, but their success has been questionable. ‘Comply-or-explain’ forms the basis of much of the UK’s soft law, aiming to solve the agency problem by creating dialogue between investors and directors. In practice however, it has certain disadvantages, meaning it risks failing to live up to expectations.

The article will then provide an examination of the developments that have come about in response to the financial crisis that have attempted to solve the aforementioned problem of investor apathy. One of these, the UK Stewardship Code, was introduced in 2010 and revised in 2012; however it still has many critics and perceived flaws. Another initiative, the recently enacted ‘say on pay’ legislation, aims to increase shareholder-director dialogue. This is also the aim of the UK Corporate Governance Code (formerly the Combined Code), section E, which was

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The final part of this article will discuss reform. In recognition of the importance of ‘comply-or-explain,’ discussions will focus on this particular soft law. There are valid arguments for keeping the soft-law approach, but it is recognised that improvements would have to be introduced to make it work effectively.\footnote{By the Financial Reporting Council, for example.} An alternative argument exists for completely abolishing ‘comply-or-explain,’ and replacing it with hard law sanctions. The United States Sarbanes-Oxley Act 2002 will be examined in order to determine whether hard law would have the effect of raising corporate governance standards, and more specifically, encouraging greater investor engagement.

2. The foundations of UK corporate governance

A. The Agency problem

The issue of to whom directors are trustees is central to corporate governance. It was at the heart of the Dodd-Berle debate,\footnote{Adolf A. Berle, ‘Corporate Powers as Powers in Trust’ (1931) 44 Harvard Law Review 1049 and ‘For Whom Corporate Managers Are Trustees: A Note’ (1932) 45 Harvard Law Review 1365; E. Merrick Dodd, ‘For Whom are Corporate Managers Trustees?’ (1932) 45 Harvard Law Review 1145.} where Dodd believed that directors should act for the community and Berle thought that they should act for the shareholders. Although Dodd won the debate, the Companies Act 2006, s172, while encapsulating a hybrid of both theories, is clearly shareholder-centred in that it states that there is a duty on a company director ‘to promote the success of the company for the benefit of its members as a whole.’\footnote{Companies Act 2006 s172(1).} Regard must be had however, to other matters such as employee interests\footnote{ibid s172(1)(b).} and the influence of the company’s actions on society and the environment.\footnote{ibid s172(1)(d).} However, the interests of shareholders (i.e. the members as a whole) are primary when promoting the success of the company. In the Companies Act 2006, a director is therefore an agent of the shareholders, and it is on their behalf that he/she must act.

Jensen and Meckling state that an agency relationship is ‘a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.’\footnote{Michael C. Jensen and William H. Meckling, ‘Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure’ (1976) 3 Journal of Financial Economics 305, 308.} Therefore, in a company, this would involve the

shareholders, as principals, delegating authority to the company director as their agent to perform a service for them. However, there is a principal-agent problem that exists which can result in corporate governance issues arising. Adam Smith is credited with recognising this ‘agency problem’ as it was he who observed that because company directors preside over other people’s money, they may be inclined to act carelessly and not look after it in the same way they would their own money. This is especially true nowadays with institutional investors typically holding shares in a variety of companies. It is possible that directors may see this as an opportunity to take advantage and act in their own interests rather than for shareholders because many institutional investors are rationally apathetic. The main solution of course, is to engage with the agent to ensure that he acts appropriately and to penalize him if he does not. Investors could therefore hold directors to account by using their votes and attending shareholder meetings, for example.

There are however reasons why some shareholders are so passive. Active engagement in governance involves time and effort and many investors prefer the benefits of ‘liquidity and diversity in their portfolios’ to the costs involved in engagement. Such costs are multiplied in the case of institutional investors. In addition, the investment mandate for asset managers will not usually require that they perform monitoring activities, and because they have the duty to invest in many different companies, they too will cite time constraints as a barrier to engagement with individual companies.

B. UK corporate governance before the 2008 global financial crisis

Prior to the 2008 crisis, UK attempts to manage the agency problem generally avoided hard law, relying instead on soft law such as voluntary guidelines and codes of practice. One of the first initiatives was the Institutional Shareholder’s Committee (ISC) statement on the ‘Responsibilities of Institutional Shareholders in the UK,’ which provided guidelines as to institutional investor actions. Whilst somewhat brief, it did consist of good principles and represented a good, basic foundation. This was followed by the Cadbury Committee’s explicit recognition of the importance of investment monitoring as a means of improving the levels of corporate governance. This report introduced the principle of ‘comply-or-explain,’ which will be examined later on in this article. Attempts to encourage shareholders

22 Kershaw (n3) 183.
25 ibid para 3.7.
engagement are therefore not new. This makes it all the more surprising that a lack of scrutiny of poorly managed companies was one of the principal reasons for the UK financial crisis. There was little in the way of recommendations for institutional investors within the Cadbury Report, and the recommendations it did contain largely repeated the ISC’s statement. An example is the recommendation that they use their votes. Collapse was followed by the Greenbury Committee and Hampel Committee Reports, but neither of these brought about significant improvements. One useful recommendation within the Greenbury Report though was director salary, and that the connection between salary and performance should be disclosed in company reports. This was subsequently incorporated into the Combined Code. The idea was that it would help lower information-gathering costs for shareholders regarding pay, thereby reducing the time and effort required to engage in board monitoring. For institutional investors in particular, this should have been a useful tool.

The first Combined Code of Corporate Governance (1998) contained a Section E, wherein recommendations aimed at institutional shareholders were set out. These did little more than replicate the principles already established by the ISC and Cadbury. The Myners Report represented the next attempt to innovate in the area of the agency problem, but again it failed to really deliver. This failure is evidenced by the fact that later editions of the Combined Code never substantially changed the 1998 version of Section E. The ISC however, did change their original statement into a formal ‘Code on the Responsibilities of Institutional Investors’ in response to further criticism from Lord Myners in 2009, who pointed out the fact that the ISC had not introduced any new material since June 2008. As was typical with corporate governance developments however, their formal Code did not substantially build upon the original statement’s recommendations. Lord Myners’ principal criticism of the ISC in 2009 was that the issue of institutional investor apathy should have been something that they should have been looking to improve. Given that Lord Myners was speaking after the crisis, his criticism may be fair. Alternatively, other developments subsequent to the ISC’s original statement did not help alleviate the agency problem either and, as already stated, the ISC document at least contained good basic principles. It is arguable therefore that the issue was not so much about the content of the ISC statement, or any of the other developments for that matter, but the fact that compliance with any of the recommendations made in each of these documents was not mandatory. This meant that it remained difficult to persuade

26 ibid paras 6.11 and 6.12.
29 Greenbury (n27) Section B.
30 Combined Code (n10).
33 Myners (n4) para 47.
institutional investors to expend time and effort on engagement, when there was nothing compelling them to do so.

All the aforementioned developments have been characterised by minor changes and reaffirmations. Their overall failure is perhaps best demonstrated by the fact that the Companies Act 2006 contains various provisions to help shareholders engage in effective dialogue with company directors and hence overcome the agency problem; however the financial crisis of 2008 came about because these provisions were not used frequently enough. Companies Act engagement provisions include, the right to vote,34 rights to requisition a meeting,35 thereby enabling hard questions to be asked of the board, and rights to have a statement of a proposed resolution distributed to the members,36 which reduces informational costs. Additionally, any long term service contract must be approved by the members,37 which improves transparency and accountability, and there is, of course, the ultimate power to actually remove a director.38 Many of these rights have existed since well before the introduction of the 2006 Act, but they were not utilised historically, by either ordinary or institutional shareholders, to any great degree. A consequence of this lack of scrutiny has been the ability of company boards to behave recklessly. Informational and time costs involved in engagement remain a significant deterrent to investors. An example of shareholder passivity is that company voting statistics are generally disappointing. This is mostly prevalent amongst institutional investors, even though their investments are supervised by professional fund managers.39 The 2006 Act attempted to solve this problem by including a provision which allows the Treasury or Secretary of State to authorise publication of details of the voting (or lack of it) by institutional shareholders.40 Paterson sees this as more of a scare tactic to encourage voluntary action.41 Nevertheless, the adoption of a hard law approach may be a step in the right direction, when measured against the largely ineffective array of soft law Codes and guidelines that existed previously. The Act additionally allows for civil proceedings to be brought in the event that regulations are ignored,42 which adds some teeth to this particular provision. The International Corporate Governance Network supplemented these provisions with a statement of principles for institutional investors, advising that ‘[a]s a matter of best practice… [asset managers]… should disclose an annual summary of their voting records together with their full voting records in important cases.’43 This advice could be

34 CA 2006 (n14) s284 contains the general rules on voting.
35 ibid ss303-306.
36 ibid ss314-317.
37 ibid s188.
38 ibid s168.
39 Kershaw (n3) 100.
40 CA 2006 (n14) s1277.
42 CA 2006 (n14) s1277(4).
strengthened by requiring that voting records be disclosed in all cases, as opposed to just important cases.

C. ‘Comply-or-explain’

Soft law developments already discussed, such as the Combined Code\(^\text{44}\) and the ISC ‘Code on the Responsibilities of Institutional Investors,’\(^\text{45}\) are voluntary. Instead of mandatory compliance, the principle of ‘comply-or-explain’ is used. ‘Comply-or-explain’ also applies to the Corporate Governance Code (a consolidation of many of these Codes and guidelines and which came into force after the crisis)\(^\text{46}\) and the Stewardship Code.\(^\text{47}\) ‘Comply-or-explain’ means that instead of setting legal rules, a company must either comply with a given Code’s provisions or explain why it has not done so.\(^\text{48}\) The main idea behind this mechanism is to create a dialogue between the investors and companies. If the company fails to adequately explain non-compliance with Code provisions, or investors are dissatisfied with the explanation given, the investors can then use their rights to ask hard questions of the board.\(^\text{49}\)

‘Comply-or-explain’ therefore aims to solve the agency problem. It is a market-based approach in that, if a corporation does not abide by the principle, its share price will likely drop due to potential shareholders choosing not to invest.\(^\text{50}\) This therefore allows a market sanction as opposed to a legal sanction and supports the soft law approach that makes up the UK corporate governance system. The main advantage of ‘comply-or-explain’ is that it promotes flexibility, recognising the fact that all companies are different and it is not practicable to have a ‘one size fits all approach to corporate governance codes,’\(^\text{51}\) and that some companies may have good reasons for deviating where they have an alternative strategy. Having said this, the statistics for those who actually say that they are in compliance with Code provisions are very high,\(^\text{52}\) but, as will be seen, these figures can be misleading.

It has already been established that a significant contributory factor to the downfall of many companies during the crisis was that investors did not adequately monitor board activity. This suggests that in practice, ‘comply-or-explain’ is not working properly. ‘Comply-or-explain’ aims to encourage investor engagement, but this was clearly lacking prior to 2008. One of the principal reasons for this is because some explanations for non-compliance with Code provisions have historically been

\(^{\text{44}}\) Combined Code (n10).
\(^{\text{45}}\) ISC Code (n32).
\(^{\text{46}}\) Corporate Governance Code (n9).
\(^{\text{47}}\) Stewardship Code (n7).
\(^{\text{48}}\) Corporate Governance Code (n9) 4.
‘brief and uninformative,’53 with ‘boilerplate statements’ deployed,54 meaning that shareholders may not have had sufficient information to ask the necessary hard questions and adequately hold boards to account. One study found that 17% of non-compliances are not even explained at all.55 While the figures have improved somewhat in recent times (one study found that 15% of UK companies did not provide an explanation),56 there is still a proportion of companies who do not explain their degree of compliance to a high enough standard.57 MacNeil and Li argue that instead of examining these uninformative and sometimes non-existent explanations, some investors will use the financial performance of the company to decide whether non-compliance has been warranted.58 In other words, these investors will not engage in monitoring as long as the company is doing well financially. When performance is lacking however, they may be more inclined to begin monitoring the board; i.e. ‘comply-or-perform.’59 A question arises as to whether, if explanations were of a high enough standard, would shareholders still use financial performance as a cue to monitor.

It seems to be the case that even when useful explanations are present, they are not always assessed. This is especially true of investors in widely-held corporations,60 the reasons for which have already been discussed. This may be one of the reasons why companies provide either poor statements or no statement at all. If their shareholders are not undertaking monitoring, then the companies will be less likely to apply ‘comply-or-explain’ if they ‘can get away with’ it.61 Instead, Moore believes that institutional investors often employ a ‘box-ticking’ approach towards engagement.62 This view is reinforced by the Association of Certified Chartered Accountants in its comments on the Walker Review.63 What this means is that investors may say that they are monitoring, but in practice no real effort is being made to engage and assess company disclosures.64 Some companies are likely to be guilty of adopting a similar approach; hence there is a real fear that abiding by

53 MacNeil and Li (n51) 489.
58 MacNeil and Li (n51) 490.
59 ibid 492.
60 Keay (n50) 19.
62 Moore (n54).
64 Keay (n50) 11.
Corporate governance codes will just become another compliance exercise as opposed to a concentrated effort to create a dialogue between the shareholders and their companies. An example is the former Combined Code’s provisions which were quite wide-ranging and lacking in specificity. A company may therefore in theory have thought that it was complying, but may in practice actually have failed to do so. It would not have provided a disclosure for deviating.\(^{65}\) This may partly explain why compliance statistics are so high.

It has been additionally suggested that another reason why decent company disclosures are not always examined is because some institutional investors do not know how to carry out their engagement responsibilities.\(^{66}\) This is portrayed by the fact that a significant proportion of director engagement arises from voting at general meetings.\(^{67}\) Investors may believe that this is the only way they have a good chance of having their voice heard, and that more direct means of communication with the board are not possible or are unknown to them. It is therefore important to make investors aware of other available avenues, such as attendance at meetings. Failing this, the trend of not assessing company disclosures, if provided, will most likely continue. This author believes however that most shareholders are aware of the necessary tools available to them for creating a more direct dialogue with the board, especially under the Companies Act 2006, but instead do not utilise them.

Another disadvantage of ‘comply-or-explain’ is the lack of accompanying enforcement. There are no penalties for those who do not abide by it, and the pitfalls associated with this were highlighted by the European Commission. They stated that voluntary law systems are often unsuccessful as a result of there being no penalties as a way of enforcement.\(^{68}\) Hooghiemstra and Van Ees also notice the significance of punishment,\(^{69}\) finding that self-regulatory systems may be ineffective in its absence. There may perhaps be a fear that applying legal sanctions to a company for providing a poor disclosure, for example, would be crossing into the realms of hard law. There is supposed to be a market sanction alongside ‘comply-or-explain,’ but there is no such thing when the mechanism fails due to uninformative company disclosures and investor apathy. Nevertheless, in terms of the Corporate Governance Code, under the United Kingdom Listing Authority (UKLA) listing rules, companies are obliged to state how they have applied the Code or explain why they have not done so.\(^{70}\) Breach of this rule could lead to sanctions involving public censure or a fine,\(^{71}\) but as Kershaw noted, the Financial Services Authority (now replaced by the Prudential Regulation Authority and Financial Conduct Authority) had not issued

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\(^{65}\) Arcot, Bruno and Faure-Grimaud (n52) 198.  
\(^{69}\) Reggy Hooghiemstra and Hans van Ees, ‘Uniformity as response to soft law: Evidence from compliance and non-compliance with the Dutch corporate governance code’ (2011) 5 Regulation and Governance 480, 481.  
\(^{70}\) United Kingdom Listing Authority, ‘Listing Rules’ 9.8.6 R (6).  
\(^{71}\) Financial Services and Markets Act (FSMA) 2000 s91.
any sanctions for this reason. This reinforces the criticism of ‘comply-or-explain,’ whereby those companies who do not abide by it will face no penalty. These particular UKLA Listing Rules appears to only exist as a scare tactic to encourage companies to either comply with Code provisions or provide informative explanations for deviating.

3. Developments post 2008 global financial crisis to encourage investor activism

A. The UK Stewardship Code

The post-crisis Walker Report condemned institutional investors for their passivity and also directed some blame at the fund managers. Walker found that the ISC Code and the Combined Code contained good principles enabling effective monitoring to take place, but believed that guarantees to abide by these provisions were insufficient. He recommended the renaming of the ISC Code as the UK Stewardship Code, the principal aim being to encourage institutional investors in particular to take their role as owners of corporations more seriously and to banish criticisms of them as ‘absentee landlords.’ This replicates similar soft law developments that occurred prior to the crisis. Another aim was to encourage institutional investors to make greater use of their rights and to adopt a more long-term trading approach to their investments, replacing the short term attitudes that many of these investors scrutinised in Walker had possessed. This sits well with Myners’ view that ‘a share certificate is a right and entitlement of ownership which carries with it certain responsibilities. It’s not a piece of paper to be traded, to be bought or sold. Companies are too important.’

The Stewardship Code purports to inspire fund managers to play a more active role in corporate governance, as well as encouraging service providers to abide by it. Its scope is therefore different to that of the Corporate Governance Code, which is aimed primarily at companies. It should be noted that a large proportion of UK shares are held by overseas investors. It is hoped that these investors will conform to the Code’s ethos in a similar manner to UK investors. This would certainly increase its influence which can only be beneficial.

After a consultation period, the Stewardship Code was published by the Financial Reporting Council (FRC) in July 2010 and was revised in September 2012.

72 Kershaw (n3) 253.
73 Walker (n6) para 5.10.
74 ibid para 5.37.
75 ibid para 5.40.
76 Stewardship Code (n7) 2.
77 Myners (n4).
78 Myners (n5).
79 Stewardship Code (n7) 2.
80 Corporate Governance Code (n9) 1.
82 It was felt that certain issues needed rectified, such as the definition and scope of stewardship and how the Code was to be implemented.
The main provisions stipulate, *inter alia*, that institutional shareholders should state how they will satisfy their stewardship responsibilities, manage their conflicts of interest, engage with their investee companies, and be willing to collaborate with other investors to make the job of monitoring easier and more effective.

B. Critique of the UK Stewardship Code

The primary disadvantage of the Code is that ‘comply-or-explain’ applies. The disadvantages of this have already been highlighted. Nobody has to comply with the Code’s principles (provided they supply an explanation) which lessens the likelihood that the Code will have any great effect on promoting investor engagement. For those who do decide to abide by its principles however, there are a host of inherent weaknesses. In comparison to some of the prior developments to it, the Code can actually be said to have regressed in some instances. For example, Principle 4 asserts that institutional investors should have ‘guidelines’ on when and how they will carry out their monitoring activities. Roach feels that this merely implies a ‘casual set of recommendations’ which may provide insufficient impetus for investors to follow them. The phraseology as originally drafted remains in the 2012 version. ‘Guidelines’ should perhaps be changed to ‘policies’ in a future update; this would imply more serious regulation requiring adherence.

The Code also fails to address other important issues. For example, because the Code operates on a ‘comply-or-explain’ basis, there is a chance that some institutional investors who do not choose to monitor will benefit from the time expended and efforts of others who do engage, resulting in inequity. One potential solution to this is to offer bonuses, such as higher dividends, to those who do engage. Furthermore, while the Code purports to encourage institutional investors to abandon their short-term attitudes, it does not explicitly advise the taking of a long-term view on trading. This is perhaps due to the fact that investors do not want to be pressured into when they can or cannot sell their holdings.

The Code’s weaknesses may be due to the fact that although there was industry consultation before its adoption in 2010, the FRC failed to consider many of the proposals. Many thought that the ISC Code, if it was to be the foundation of the Stewardship Code, would have to be significantly improved, but this clearly did not happen. The principles remained the same and a significant proportion of the

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83 Stewardship Code (n7) 6.
84 ibid.
85 ibid 7.
86 ibid 8.
88 Stewardship Code (n7) 8.
90 ibid.
92 ibid 137.
93 Roach (n89) 467-468.
guidance replicated the ISC Code *verbatim*. This may be attributable to a desire to maintain the impetus provided by the Walker Review by speedily implementing the Stewardship Code.\textsuperscript{94} This lack of meaningful reform may also have ramifications internationally, in that the UK is perceived to be a world leader in corporate governance. Consequently, reforms such as the UK Stewardship Code would be expected to inspire progress in other countries.\textsuperscript{95} Roach, for example, takes the following view:

It is unfortunate that the world’s first Stewardship Code was established on the basis of expeditiousness rather than on a desire to establish a comprehensive and forward-looking set of engagement principles and must therefore be regarded as a missed opportunity to encourage greater investor engagement, not only to the UK but also around the world.\textsuperscript{96}

Despite the aforementioned critique, the FRC has demonstrated it is not completely unresponsive to criticism, as its 2012 Code edition introduces greater detail to the accompanying guidance. The fact remains however, that the seven principles in the ISC Code, the 2010 Stewardship Code and the 2012 Stewardship Code remain the same (bar a few words). Most of the accompanying guidance remains unchanged and there remain several weak provisions requiring improvement, if institutional investors are to overcome hurdles to greater engagement.\textsuperscript{97} As matters currently stand however, the FRC has implied that it does not intend to make any substantial changes to the Code in 2014.\textsuperscript{98}

Another disadvantage of the Code is its territorial limitation. It is a fact that a large percentage of UK shares are held by foreign investors, who are therefore outside the Code’s ‘jurisdiction.’ In 1981, shareholdings of overseas investors amounted to 3.6\% of the UK market, but this figure rose to 41.5\% by 2008.\textsuperscript{99} By 2012, this figure was estimated to have become 53.2\%,\textsuperscript{100} and it is likely to climb further in light of globalisation. Overseas investors, while not obliged to adhere to the principles of the Code, are encouraged to do so. For example, although the Walker Review recommended keeping the Code ‘UK-centric,’\textsuperscript{101} it was thought that foreign

\textsuperscript{95} Roach (n89) 478.
\textsuperscript{96} ibid 479.
\textsuperscript{97} For example, (in addition to what has already been discussed) the use of the word ‘should’ is not as strong as ‘must’ in Principle 3.
\textsuperscript{100} Office for National Statistics (n81) 1.
\textsuperscript{101} Walker (n6) para 5.41.
investors might choose to comply with its provisions anyway, meaning that the Code would be more likely to be a success and that greater monitoring would be promoted. A potential disadvantage exists, of course, in the potential confusion that could result if foreign investors conformed to a UK-centred Code set against rules they were required to abide by in their own nations. If compelled by circumstances not to comply with the UK Code, the UK Code’s influence would consequently be reduced.

Finally, enforcement of the ‘comply-or-explain’ principle as it relates to the Stewardship Code should be discussed. The FRC website publicises details of corporate institutions that state on their website that they have applied the principles of the Code. Whilst this appears positive, Roach observes that those who do not supply adequate disclosure for non-compliance will typically not be penalized. This is despite the fact that the Walker Review asserted that the (then) FSA should require fund managers to disclose their degree of compliance on their company website. Moreover, this recommendation was implemented by rule 2.2.3R of the Conduct of Business Sourcebook (COBS), with breaches of said rule sanctionable by public censure or financial penalties. Another oddity is that rule 2.2.3R only mentions fund managers as being required to ‘comply-or-explain,’ despite the fact that they generally do not even have stewardship activities as part of their mandate. Furthermore, they rarely possess the resources to monitor. Other institutional investors (who should be carrying out monitoring activities) and service providers, appear to escape the COBS provisions, or anything else for that matter, compelling them to ‘comply-or-explain.’ Roach suggests that one solution might be the imposition of a loss of voting rights on those investors who do not abide by the principle.

In assessing the effectiveness overall of the Stewardship Code, it has been reported that engagement between investors and directors in larger companies has improved, but lack of investor activism for medium-sized companies remains problematic. Moreover, restrained resources are still cited as an excuse not to monitor directors. Whilst it was to a degree inevitable that introducing the Stewardship Code would produce at least some encouraging results, bigger changes will have to be implemented to achieve the seismic shift in investor culture required to prevent another corporate governance crisis such as that measurable in 2008.

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102 Roach (n89) 471.
103 This is where the list is found: <www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code/UK-Stewardship-Code-statements.aspx> accessed 17 October 2014.
104 Roach (n89) 475.
105 Walker (n6) para 5.40.
107 FSMA 2000 (n71) ss205-206.
108 Investment Management Association (n21).
109 Roach (n89) 475.
110 FRC (n98) 22.
111 ibid 23.
C. Other post-crisis developments

The most significant of these developments is perhaps the ‘say on pay’ legislation.\(^{112}\) This differs from the Stewardship Code in that it is legally binding, with sanctions possible for non-compliance in appropriate circumstances. The Enterprise and Regulatory Reform Act 2013, in the UK, introduces important changes in director remuneration policy.\(^{113}\) Company shareholders now possess greater combined power in the form of a binding vote on director pay,\(^{114}\) and there is an obligation on shareholders to enhance the remuneration policy every three years.\(^ {115}\) Director pay must either adhere to the policy or be approved by the shareholders. Shareholders therefore have a direct say on the remuneration company directors receive. These provisions aim to provide shareholders with an additional means of scrutinising their investee companies, and the binding vote in particular allows them to hold directors to account. This legislation only applies however to directors of quoted companies, and although it was companies of this size that played the greatest part in the 2008 crisis, it does not apply to overseas companies listed on the UK stock market either. It is therefore arguable that the scope of the legislation has been narrowed slightly.

The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013\(^ {116}\) also represents a welcome addition to corporate governance. They outline the reporting requirements for companies’ future remuneration policies and Annual Reports. They additionally state that companies should, *inter alia*, state the salary each director receives, clarify individual director performance and state how the company has decided on the remuneration level for directors.\(^ {117}\) This enables investors to ensure that directors are not being rewarded for failure and are not being paid more than their performances merit, – a practice which occurred all too frequently during the crisis. Moreover, the company must make clear how the components of a director’s remuneration back the company’s immediate and future plans.\(^ {118}\) The Regulations aim to improve transparency, thereby reducing the informational costs often borne by shareholders when attempting to engage. Although not applicable to small businesses, it is perhaps less likely directors in such companies would be rewarded for poor performances anyway, as their behaviour will most likely be under greater scrutiny as a result of director activities being more visible. A small business is one in which two of the following conditions are satisfied: Annual turnover is less than £6.5 million; the

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\(^{112}\) UKERR Act 2013; Large and Medium-sized Companies and Groups Regs 2013; CA 2006 Regs 2013 (n8).

\(^{113}\) UKERR Act 2013 (n8) ss79-82.

\(^{114}\) ibid s79.

\(^{115}\) ibid.

\(^{116}\) Large and Medium-sized Companies and Groups Regs 2013 (n8).

\(^{117}\) ibid Schedule 8.

\(^{118}\) ibid.
balance sheet total is less than £3.26 million; the average number of employees is less than 50.\textsuperscript{119}

The Companies Act 2006 (Strategic Report and Directors Report) Regulations 2013\textsuperscript{120} provides for the publication of a strategic report by certain companies.\textsuperscript{121} This report should contain, \textit{inter alia}, information on how the company has performed during the previous year and a description of its plans and business model.\textsuperscript{122} This will allow investors to gain greater insight into the governance of their chosen investee companies, and will hopefully help them assess director performance to a greater degree. As a result of this secondary legislation, investors should be better equipped to ask hard questions of the directors if the strategic report reveals that they are under-performing as regards promoting the success of the company. The Regulations do not however apply to those entitled to the small companies’ exemption,\textsuperscript{123} thereby reducing their scope, and the FRC have stated that the strategic report does not substantially differ from the business review it replaced.\textsuperscript{124} The contribution to better corporate governance that these Regulations bring is therefore debatable.

The investor forum mooted following the Kay report,\textsuperscript{125} and in operation from June 2014 represents another corporate governance initiative. The forum aspires to help control director behaviour and banish short-termism\textsuperscript{126} through the establishment of an ‘engagement action group’ comprising investors from around the world.\textsuperscript{127} This may allow investors to satisfy principle 5 of the Stewardship Code which encourages collective action.\textsuperscript{128} The group is expected to meet regularly, and will consist of shareholders designed to be representative of other investors.\textsuperscript{129}

The final development requiring discussion is Section E of the Corporate Governance Code. The main principles in the 2012 version replicate those outlined in 2010. E.1 states that there should be engagement between investors and the directors, and that it is the duty of the directors to make sure that this happens.\textsuperscript{130} A noticeable

\textsuperscript{120} CA 2006 Regs 2013 (n8).
\textsuperscript{121} ibid. regs 2-5 are the main provisions on the strategic report.
\textsuperscript{122} ibid reg 3.
\textsuperscript{123} For the purpose of the legislation, regulation 3 provides that: “A company is entitled to small companies exemption in relation to the strategic report for a financial year if – a) it is entitled to prepare accounts for the year in accordance with the small companies regime, or b) it would be so entitled but for being or having been a member of an ineligible group.”
\textsuperscript{125} Kay (n11).
\textsuperscript{126} David Oakley, ‘Investors invited to join forces to rein in wayward governance’ Financial Times (2 December 2013) <www.ft.com/intl/cms/s/0/3a3de368-5b42-11e3-a2ba-00144feabd0.html#axzz2n0yZ6EjO> accessed 5 October 2014.
\textsuperscript{127} ibid.
\textsuperscript{128} Stewardship Code (n7) 8-9.
\textsuperscript{129} Oakley (n126).
\textsuperscript{130} Corporate Governance Code (n9) 24.
disappointment though is that there is repeated emphasis on major shareholders in the supporting principles that follow.\textsuperscript{131} Although major shareholders have been primarily responsible for failing to curb poor director behaviour, ignoring the contribution of smaller shareholders reduces the scope and effect of section E’s provisions. Footnote 25 does state that there should be equal treatment of all shareholders as regards access to information, but this is clearly not the case. In addition, the fact that there ‘should be a dialogue’\textsuperscript{132} as opposed to ‘must be a dialogue’ serves to highlight its lack of force. Future editions might wish to strengthen this provision. This would place greater pressure on those who choose not to comply with the Code provisions to make sure that an effective dialogue definitely happens. The main principle outlined in section E.2. asserts that the annual general meeting (AGM) should be used as means of engaging with investors and encouraging their participation. Whilst this is \textit{prima facie} beneficial as regards communication and therefore governance, the use of ‘should’\textsuperscript{133} is not as strong as ‘must.’ It also has to be remembered that the Code is only soft law and that it is subject to ‘comply-or-explain’ and its associated disadvantages previously discussed. Moreover, Section E of the Code is essentially a consolidation of many of the developments which came before the crisis. It therefore does not result in substantial improvements that solve the problem of investor apathy. The 2008 edition of the old Combined Code actually goes further in tackling such apathy than the 2012 version of the Corporate Governance Code, as it has a complete section devoted to institutional shareholders, rather than a paragraph.\textsuperscript{134}

4. Reform

A. Keep ‘comply-or-explain’?

Despite the criticisms of ‘comply-or-explain’ outlined earlier, Keay feels that the framework could be conserved, but buttressed through the establishment of a monitoring body to assess company disclosures.\textsuperscript{135} The UK currently has no such body (despite some EU Member States having one);\textsuperscript{136} instead assessment is predominantly left to the shareholders.\textsuperscript{137} In other EU Member States, regulating bodies possess discretionary powers to issue penalties for uninformative statements.\textsuperscript{138} This represents a hybrid approach, which maintains ‘comply-or-

\textsuperscript{131} ibid.
\textsuperscript{132} ibid.
\textsuperscript{133} ibid 25.
\textsuperscript{134} Combined Code (n10) 21-22.
\textsuperscript{135} Keay (n50) 22.
\textsuperscript{138} Keay (n50) 24.
explain,’ but introduces a hard law element by having a regulator determine whether statements are of sufficient quality. This therefore has the potential to eradicate one of the biggest disadvantages of ‘comply-or-explain.’ Companies would retain the choice of whether or not to abide by Code provisions, but would have to provide a statement of sufficient quality to give investors enough information to enable them to engage in dialogue with the board, or risk punitive measures.

A regulator such as Keay describes would ensure that company statements are of a high enough standard, and that shareholders might feel more secure. The threat of enforcement might prevent managers from choosing not to disclose at all or providing uninformative statements. Conversely however, it would involve extra costs, meaning that some of the benefits of a voluntary approach were negated. The main problem with Keay’s view is that it is meant to be the decision of the shareholders whether to accept or reject company explanations and whether or not to hold the company to account and dismiss directors. The introduction of a regulatory body is therefore viewed with a degree of negativity in some quarters as it signals a move away from the self-regulating approach. The FRC are concerned that this would lead to a situation where company solicitors would confirm with the regulator when preparing a disclosure that it conformed to a high enough standard, meaning that shareholders would be left out altogether. They believe that if there is to be a monitor, such a body should not replace the shareholders. The European Corporate Governance Forum shares this view.

The FRC suggests an alternative approach involving a lesser role for the monitoring body and lawyers. They propose that guidelines should be established outlining what constitutes a good disclosure statement and that once these guidelines were issued, investors could then look at their particular investee company disclosures and tell the monitoring body which explanations they felt did not reach the threshold set out in the guidelines. The monitor could then go about securing improved disclosure from the company in question. The FRC have produced some guidance on the content of explanations, so it would seem that there is a framework already in place for ascertaining what constitutes an appropriate explanation under ‘comply-or-explain.’ The approach suggested by the FRC, although allowing investors a potentially greater role compared with the scheme suggested by Keay still fails to solve the problem of shareholders not being able to

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139 ibid 28.
140 ibid.
142 Keay (n50) 25-26.
143 ibid 6.
144 FRC (n57) 3.
146 Keay (n50) 27.
147 FRC (n137) 6.
148 FRC (n57).
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assess all disclosures. Moreover, it has been suggested that this process could take a long time, and that extra shareholder effort is involved in that they would have the responsibility of making any monitoring body aware of the uninformative explanations. This might make this particular task unappealing, especially for institutional shareholders, who would be undertaking this process on behalf of many companies. The FRC’s guidance as to what constitutes a good company explanation, although welcome, is arguably rather brief and generalised in its current form. More extensive guidelines may therefore be required.

Given the problems, as highlighted, that the presence of an oversight body can bring, there must be other ways of promoting improvements in explanations so that investors can engage with their investee companies more effectively. Section A of the Corporate Governance Code focuses on ‘Leadership’ and emphasises the role that the Chairperson can play. Perhaps as a result of this, many companies now state on their website their commitments to good corporate governance principles and include a statement from their chairperson. Although these introductory declarations may be general in nature, it is hoped that they will encourage companies to abide by ‘comply-or-explain.’ The Association of British Insurers found that companies who have published such statements tend to have more informative corporate governance explanations. This demonstrates that something as simple as a chairperson statement can have a positive effect on corporate governance and, more particularly, on the quality of disclosures. The significance of this practice is recognised in the Disclosure and Transparency Rules 7.2.1 R, which states that certain companies must have a corporate governance statement in their director’s report.

In addition, ‘standardised [disclosure] forms’ are used in specific EU countries such as Spain and Hungary. In these nations the amount of disclosures provided is generally greater compared to other countries where this method is not used. This is therefore clearly beneficial. It is important however to construct such forms in a way which requires each Code provision to be specifically referred to rather than just providing a plethora of general details, as this yields the positive result that more disclosures are actually given. Not only are more explanations provided, but by providing specific information the explanations are more informative. This allows a greater degree of engagement, as investors can clearly see which exact principles are or are not being complied with. In addition, this approach

149 Keay (n50) 27.
150 ibid.
151 Corporate Governance Code (n9) 8-10.
154 United Kingdom Listing Authority, ‘Disclosure Rules and Transparency Rules’ 7.2.1 R.
155 RiskMetrics Group (n136), 181.
156 ibid.
157 ibid.
could help corporations in that they would only be required to make small amendments year after year, after completing the form the first time.\textsuperscript{158} A potential downside to the use of such forms is that disclosure becomes a ‘box-ticking’ exercise.\textsuperscript{159} It would be important therefore to construct them in a way that prevented this from happening.\textsuperscript{160}

One potential solution would be to have a web-based scorecard scheme that would recognise companies that are performing well and identify those actually abiding by Code provisions in practice. The use of ‘kite marks’ and ‘quality rankings’ has been suggested as a useful way of awarding those high performers.\textsuperscript{161} Given that the public would also have access to this information, this would have the consequence of ‘naming and shaming’ (and threatening the reputation) of those companies not exhibiting the requisite degree of participation. Moreover, especially with regards the Stewardship Code, such a system enables investors to act as stewards. They would be able to ‘review and rate companies,’\textsuperscript{162} allowing them to scrutinise them very easily without having to expend time and effort in attempting to speak directly with a director or convening a board meeting. It would also publicise those investors and fund managers who are not abiding by the required principles.\textsuperscript{163} Another benefit of the system is that it would permit non-UK investors to voice their own concerns on corporate governance issues.\textsuperscript{164} Investors worldwide, and not just the UK, are affected by poorly managed UK companies, so it is important to have a forum which allows these investors to contribute.

H. Abolish ‘comply-or-explain’?

During the FRC’s Call for Evidence in 2009 as part of its review of the Combined Code,\textsuperscript{165} one respondent said that as a result of the general public having a lack of faith in the soft law system, ‘comply-or-explain’ should be abolished, with the FRC taking over the job of monitoring and penalizing those who fail to abide by Code provisions.\textsuperscript{166}

The introduction of mandatory law is definitely understandable in light of the crisis, and with the possibility of legal sanctions and the presence of a regulator with enforcement responsibilities it would be hoped that standards of corporate governance would improve. Other advantages include the eradication of the conflict of interest currently existing under the ‘comply-or-explain’ regime wherein the directors decide whether or not to comply with Code provisions, resulting in

\textsuperscript{158} ibid 182.
\textsuperscript{159} ibid 181.
\textsuperscript{160} ibid.
\textsuperscript{161} Resiberg (n91) 141.
\textsuperscript{163} ibid 49-50.
\textsuperscript{164} ibid 50.
decisions occasionally being made which are not always necessarily in the best interests of the company or stakeholders.\textsuperscript{167} Investor assurance would also be enhanced,\textsuperscript{168} as it is thought investors would rather invest in a company subject to hard law. The introduction of mandatory law would certainly have a positive effect on the problem of investor apathy. For example, fund managers and other institutional investors would be made to comply with the principles within the Stewardship Code. Similarly, companies would be made to comply with section E of the Corporate Governance Code, meaning that by law, the board would be obliged to engage in a dialogue with shareholders and the AGM would have to be used as a means to converse with shareholders.\textsuperscript{169}

Interestingly however, because mandatory corporate governance laws with legal sanctions would have the effect of imposing stricter conditions and obligations upon directors it could be argued that it would not consequently be necessary for investors to engage. For example, principle A.2. of the Corporate Governance Code states that there must be a division of responsibilities and that no one person should have unrestricted powers.\textsuperscript{170} What is the point therefore in an investor spending time to assess whether this principle is being complied with, where the regulator is obliged to do so, and issue legal sanctions where appropriate, under a hard law regime? Moreover, under the US Sarbanes-Oxley Act 2002, which was introduced following a number of high profile company scandals and after the failures of Enron, WorldCom and many others, US shareholders now have limited rights in many major areas in their investee companies in comparison with foreign competitors.\textsuperscript{171} This potentially restricts their degree of effective engagement, so if mandatory law were to be introduced in the UK, it would have to ensure that the rights of shareholders were not unduly restricted. Mandatory law can have various other negative effects unrelated to investor monitoring. The destructive effect it has wrought on US markets due to the creation of disparity in legal rules between US and foreign markets\textsuperscript{172} would perhaps suggest that introducing hard corporate governance laws to the UK may not be such a good idea, especially as other EU countries use ‘comply-or-explain’ in their regulatory approaches. In addition, Ribstein identifies the extra costs of introducing regulation, such as firms having to spend more time and effort obtaining information and paying auditors.\textsuperscript{173}

Walker has stated that mandatory law may result in unforeseen repercussions and that positive development is ‘more likely to be achieved through…non-statutory routes to implementation so that boards and their major owners feel “ownership” of

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\textsuperscript{168} ibid 12.

\textsuperscript{169} Corporate Governance Code (n9) 24-25.

\textsuperscript{170} ibid 9.


\textsuperscript{172} ibid ‘Executive Summary’ 5.

good corporate governance.’174 There is therefore a clear preference here that the directors should have a choice of whether to comply with certain provisions and that it should be the job of the shareholders to assess whether they are correct in their decision making. This view is supported by many EU respondents.175 A contributory factor to this strong opposition in the UK may perhaps be as a result of the fact that the Companies Act 2006, at nearly 700 pages only fully came into force in October 2009 following a 10 year review process that paved the way for it. This has perhaps led commentators to believe that it provides enough detail and ‘appropriate standards of duty and accountability so nothing further is required.’176

5. Conclusion

The 2008 global financial crisis represented a wake-up call for many, not least the institutional investors who own a huge percentage of the shares in listed UK companies. They have been lambasted for failing to look after their investments, and were blamed in part for failing to prevent the crisis.

The root of the problem can be traced back to the agency dilemma that exists between directors and shareholders. This is mostly an issue in widely-held companies, where directors do not perform their role as agents adequately enough, and institutional investors can be apathetic due to resource constraints. This means that poor director behaviour is not scrutinised frequently enough. There have been an abundance of soft law developments aimed at encouraging institutional investors to monitor their investments more closely and thereby solve the agency problem, but many of these have failed in their objective. Moreover, the Companies Act 2006 contains rights which are available to shareholders to enable them to engage, but the crisis showed that their use was simply not forthcoming, allowing directors to continue to behave freely and negligently on occasions. ‘Comply-or-explain’ has been at the centre of many of the Codes and guidance produced and can be said to have been a stalwart of UK corporate governance since the 1992 Cadbury Report. In theory, it appears a useful tool in addressing the investor apathy problem, but in practice it fails to deliver. To be successful, explanations for deviating from Code provisions have to be enlightening and investors have to actively engage in assessing these explanations; neither has happened to a sufficient degree.

The Stewardship Code was introduced in response to the crisis, but it has many inherent disadvantages. These include the fact that its coverage is limited, compliance is voluntary and for those who do comply, there are many weak provisions, some of which actually regress on previous soft law developments. The ‘say on pay’ legislation on the other hand has more potential to promote greater engagement with companies. It compels companies to disclose details of director pay, and gives the shareholders a direct say on what they earn. This reduces informational costs for investors and promotes transparency, thereby helping eradicate some of the barriers to engagement. The investor forum is a welcome

174 Walker (n6) ps 9-10.
175 RiskMetrics Group (n136) 139-142.
addition, as it recognises the importance of collective engagement in monitoring company boards, thereby allowing investors to pool their resources. Finally, the Corporate Governance Code was presented. Unfortunately, as with the Stewardship Code, it is soft law and involves ‘comply-or-explain,’ with its known disadvantages. Section E additionally fails to expand substantially on previous soft law Codes and guidelines.

It appears therefore that ‘comply-or-explain,’ as it is currently implemented, fails to carry out its intended job. It is therefore almost certain that if it were decided to maintain it as the regulatory approach of choice, then wholesale changes to its operation would be required. Introducing oversight by a monitoring body has been suggested as a way of assessing the adequacy of company disclosures, but some view this as eradicating the self-regulatory approach and removing the role of the shareholders. It would therefore have to be ensured that, if a monitoring body were to be present, it would have defined responsibilities and would instead operate in support of shareholders, as opposed to instead of them. Regulatory oversight aside, further promotion of the practice whereby chairpersons place introductory corporate governance statements on their company websites, and the introduction of standardised disclosure forms will improve disclosure quality. However, even if the problem of uninformative explanations was solved, another downside to ‘comply-or-explain’ is the fact that a box-ticking approach might be the result. To solve this, some have suggested the introduction of an internet ‘scorecard’ scheme which would identify those who are taking compliance seriously, and it would also have the benefit of allowing investors to act as stewards by rating companies on their performance. There are also some strong arguments for abolishing ‘comply-or-explain’ and introducing mandatory law instead. This would improve compliance with Code provisions and would hopefully go some way to solving the investor apathy problem by making the Stewardship and Corporate Governance Codes legally binding. However, the ill-fated US Sarbanes-Oxley Act 2002 perhaps suggests that hard law is not the answer, and indeed the UK and EU have made their opinion clear that ‘comply-or-explain’ is here to stay.

It is too early to gauge whether investors, and institutional investors in particular, have taken greater care over their investments since the 2008 crisis. Evidence regarding the effectiveness of the Stewardship Code has revealed that, on the whole, engagement has been more forthcoming in larger companies, but that substantial barriers still remain. The ‘say on pay’ legislation and the investor forum definitely have the potential to solve the problem of investor apathy, but as these are only recent developments, ‘wait and see’ is the most prudent course of action for change advocates at present.
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