THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Dialogue in corporate governance

Beyond the myth of Anglo-American corporate governance

Business dialogue

Board responsibilities and creating value

Demonstrating leadership and accountability

Dialogue in corporate governance

The globalisation of capital markets and capital flows, corporate scandals and newly developing economies are encouraging demands for consistency in corporate governance practices so as to reduce complexity and confusion. Dialogue can help facilitate a better understanding of different approaches to corporate governance and foster an appreciation of equivalent systems.

Difficulties arise in striving to achieve a single, global approach to corporate governance. There are too many deep-rooted cultural and structural differences for a single approach to work equally well in all countries and for all companies regardless of their stage of development and business. The ICAEW has launched the *Dialogue in corporate governance* initiative to challenge commonly held assumptions, identify fundamental questions, set challenges for future research and generate practical proposals. This will include:

- **Beyond the myth of Anglo-American corporate governance** – Contrasting US and UK securities markets and how they impact national and international policy, investment, business and accounting.
- **EU approaches to corporate governance** – Contrasting models of corporate governance in EU Member States, drawing out potential implications for future convergence.
- **Matching corporate governance to investor needs** – Exploring the different sources of finance as businesses evolve and the implications for corporate governance.

About the ICAEW

The ICAEW is the largest professional accountancy body in Europe and has over 128,000 members in 142 countries worldwide. Since the establishment of the Cadbury Committee in 1991, the ICAEW has played a significant role in the development of corporate governance in the UK.

If you would like to know more about *Dialogue in corporate governance* or *Beyond the myth of Anglo-American corporate governance* and relevant events and publications visit www.icaew.co.uk/dialogueincorpgov

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Contact the author

For more information about this paper or the *Beyond the myth of Anglo-American corporate governance* initiative please contact:

Kerrie Waring
Corporate Governance Manager, ICAEW

Email: kerrie.waring@icaew.co.uk
Telephone: +44 (0)20 7920 8714

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Scope and use

Corporate governance is a broad discipline and this discussion paper is not intended to cover every aspect of corporate governance. It provides information on issues raised in the *Pressure Points* consultation paper and generally focuses on publicly quoted companies and institutional investors, particularly those operating internationally.

This discussion paper should be read in conjunction with the other papers in the *Beyond the myth of Anglo-American corporate governance* series focused on policy, investment and accounting issues and the *Pressure Points* consultation.

Beyond the myth of Anglo-American corporate governance

In June 2005, the Institute of Chartered Accountants in England & Wales (ICAEW) launched the *Beyond the myth of Anglo-American corporate governance* initiative. Its aim is to explore differences between US and UK corporate governance systems and the pressures these differences create for international business and investment. The intention is for this work to help inform policy makers on both sides of the Atlantic.

As part of the initiative the *Pressure Points* consultation paper was published in December 2005 and is relevant to boards, investors, the accountancy profession and policy makers. It highlights 21 questions representing some of the most challenging aspects of cross-border corporate governance and the comparability of US and UK governance systems.

As context for responses to the *Pressure Points* consultation, four discussion papers provide information on the current state of corporate governance in the US and the UK.

- **Policy dialogue**: ***Effective corporate governance frameworks – encouraging enterprise and market confidence***

- **Business dialogue:** ***Board responsibilities and creating value – demonstrating leadership and accountability***

- **Investment dialogue:** ***Shareholder responsibilities and the investing public – exercising ownership rights through engagement***

- **Accounting dialogue:** ***Disclosure responsibilities and building trust – promoting transparent and reliable information***

The initiative also encourages on-going dialogue through face-to-face meetings. At the ICAEW transatlantic roundtable in Washington DC in December 2005, the importance of dialogue around corporate governance for global capital markets was emphasised by SEC Commissioner Cynthia A. Glassman:

'We have much to learn from each other on how to regulate wisely and make global markets efficient... Our analysis of regulatory policy needs to be rigorous, yet flexible. We need to be clear about our goals, but recognize that there is more than one way to achieve them.'[1]

A paper summarising the findings of the *Beyond the myth of Anglo-American corporate governance* initiative is expected to be finalised in late 2006. It will include evidence from responses to the *Pressure Points* consultation and feedback from face-to-face meetings and roundtable events on both sides of the Atlantic.

[1] Remarks of SEC Commissioner Cynthia A. Glassman at the ICAEW *Beyond the myth of Anglo-American corporate governance* roundtable, Washington DC, 6 December 2005.

Board responsibilities and creating value

Demonstrating leadership and accountability

Contents

Introduction		4
1.	**Directors' duties**	6
1.1	Company law and directors' duties	6
1.2	The fiduciary duty of loyalty and securities regulation	7
1.3	The duty of care and the US Business Judgment Rule	9
1.4	The duty of care and the UK Insolvency Act 1986	10
1.5	Directors' liability	11
2.	**Board structure and the role of non-executive directors**	14
2.1	The role of the board	14
2.2	The attributes of non-executive directors	15
2.3	Board nomination committees	15
3.	**Leading the board**	17
3.1	Separating the roles of the chairman and CEO in the UK	17
3.2	Clarifying the role of the senior independent director	18
3.3	Combining the role of the chairman and CEO in the US	18
3.4	The emergence of the lead independent director in the US	19
4.	**The independence of non-executive directors**	21
4.1	The Combined Code's recommendations	21
4.2	Tests under NYSE listing rules	22
4.3	Contrasting requirements for dual-listed companies	23
5.	**Rewards and performance**	25
5.1	Level and make-up of executive remuneration	25
5.2	Incentivising non-executive directors	27
5.3	Performance factors and measures	28
5.4	Role and composition of the remuneration committee	29
5.5	Disclosure and accountability to shareholders	30
Useful contacts		32

Introduction

The perception of an Anglo-American model of corporate governance often stems from similarities between US and UK companies in terms of share ownership, board models and market requirements for high levels of information disclosure. However, while these similarities exist, the responsibility, accountability and power accorded to directors and shareholders in each country are based on inherently different regulatory and cultural traditions.

Stock exchanges in the US and the UK are amongst the oldest and most liquid in the world and attract high investor confidence. The London Stock Exchange (LSE) is the only exchange in the UK and comprises the Main Market for established companies and the Alternative Investment Market (AIM) for smaller companies. By contrast, the size of the US economy accommodates three stock exchanges being: the New York Stock Exchange (NYSE) predominant in the large-cap company market; NASDAQ which is popular with high-tech and growing companies; and the American Stock Exchange (AMEX) which mainly comprises smaller companies. US and UK exchanges are also amongst the largest in the world by market capitalisation as indicated in Table 1 below:

Table 1: Comparison of domestic stock market capitalisation[3] ($ millions)

Stock Exchange	End 2005
New York Stock Exchange	13,310,592
Tokyo Stock Exchange	4,572,901
NASDAQ	3,603,985
London Stock Exchange*	3,058,182
Euronext	2,706,804
Deutsche Borse	1,221,106

* Includes approximately 97,200 ($ million) for AIM

Stock exchanges in the US and the UK attract significant numbers of international companies. The US accounts for more companies listed on the LSE than any other country outside the UK and Ireland,[4] while the UK accounts for the largest number of foreign registrants of the Securities and Exchange Commission (SEC) after Canada.[5]

Increasingly international business, coupled with cross-border share ownership, means that a growing number of companies can no longer operate under one set of corporate governance guidelines. They must take into consideration the laws, market regulation and listing rules of the country in which they are incorporated and listed together with requirements in other countries which may conflict.

[3] 'Domestic Market Capitalisation', Time Series Statistics and 'SME Domestic Market Capitalisation', Annual Statistics, World Federation of Exchanges, 22 May 2006.

[4] London Stock Exchange Statistics, June 2005.

[5] 'Foreign companies registered and reporting with the U.S. Securities and Exchange Commission', The Office of International Corporate Finance, Division of Corporate Finance, U.S. Securities and Exchange Commission, December 31, 2004.

This discussion paper, *Board responsibilities and creating value – demonstrating leadership and accountability*, describes traditional business practice, cultural norms and differences in behaviour between US and UK market participants. In particular, it addresses the role, responsibilities and powers of directors in each jurisdiction. This paper also provides information relevant to the questions in the *Business dialogue* section of the *Pressure Points* consultation paper. These questions are reproduced below and cross-referenced to the relevant pages in this paper:

	Pressure Points **questions**	**Page**
Q10.	How does the Business Judgment Rule impact upon the ability of US directors to discharge their fiduciary duties and is there any substantive difference from the position in the UK?	6
Q11.	How do differences in the relative roles and proportions of non-executive directors and executive directors in the US and the UK impact on company performance?	14
Q12.	What are the key benefits and/or disadvantages of either separating or combining the positions of the Chairman and CEO?	17
Q13.	Are independence criteria for directors different in substance between the US and the UK?	21
Q14.	To what extent is it seen as feasible or desirable in the US and the UK for levels of compensation to be influenced by investors or regulated by governments?	25
Q15.	Is company performance enhanced if non-executive directors are compensated with stock options or other performance-related incentives?	25

1. Directors' duties

Directors in both the US and the UK are empowered to manage a company's affairs and are accountable to shareholders. They are obliged to exercise their powers in a fiduciary capacity and with care. How directors exercise their powers and the degree to which the law, for example the US Business Judgment Rule, supports directors in taking calculated business risks may differ between the US and the UK.

The *Pressure Points* consultation paper raises the following question:

Q10. How does the Business Judgment Rule impact upon the ability of US directors to discharge their fiduciary duties and is there any substantive difference from the position in the UK?

In considering this question, the following areas are relevant:

- The general duties of directors and company law frameworks.
- The duty of loyalty, the duty of disclosure and securities regulation.
- The duty of care, the US Business Judgment Rule and the UK Insolvency Act.
- Increasing regulation and directors' liability.

1.1 Company law and directors' duties

In the US, company law ('corporation law') differs from one state to another leading to some variation in directors' responsibilities and shareholders' rights. The state of Delaware has a long history of company law and attracts over half of all US publicly quoted companies. Most states (excluding Delaware) adopt the Model Business Corporation Act as a foundation for company law. In the UK, companies incorporated in England and Wales are governed by the Companies Act 1985 and the Companies Act 1989.

Board members in both the US and the UK are empowered to manage the affairs of a company and may delegate certain responsibilities to executive directors and board committees. These powers are provided for in company law and in a company's incorporation documents. In the UK, Table A (a model set of articles for a company limited by shares) states that a director *'may exercise all of the powers of the company.'* [6] UK companies may adopt Table A as a default set of Articles of Association or alternatively create their own ensuring that they comply with the Companies Acts.

Both the US and the UK have common law systems (i.e. laws evolve on a case-by-case basis through judicial precedent) and provide that directors are obliged to exercise their powers in the best interests of the company. They are therefore accountable to the owners of the company, i.e. the shareholders, for the ways in which they exercise their powers. This is made explicit through judgements such as the case of *Dodge v Ford Motor Co*. (1919) where the court ruled that:

'A business corporation is organised and carried on primarily for the profit of the stockholders. The powers of directors are to be employed for that end.'

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[6] Companies Act 1985, Table A, reg. 70.

Directors owe duties to the company, the most fundamental being the fiduciary duty of loyalty and the duty of care. These obligations and duties are applicable to both executive ('management') and non-executive directors ('non-management') alike. The importance of directors' duties is summarised by Ira M. Millstein, Senior Partner at Weil Gotshal & Manges LLP, as follows:

'Fiduciary duties embody the notion of how and in whose interests officers and directors are supposed to act, set the standard by which director and officer actions are to be judged and, therefore, provide a basis for the enforcement of investor rights under any system of law.' [7]

UK company law is currently undergoing comprehensive reform which aims to clarify and simplify certain areas of existing company law. This includes increased clarity around directors' obligations to the company, its members and other stakeholders as part of a wider drive to *'enhance shareholder engagement and a long-term investment culture.'* [8]

The Company Law Reform Bill proposes a Statutory Code for Directors' Duties (the Code)[9] which would be owed to the company in place of the corresponding common law. The Code proposes that a director has a duty to:

- Act within powers conferred.
- Promote the success of the company for the benefit of its members as a whole.
- Exercise independent judgement.
- Exercise reasonable care, skill and diligence.
- Avoid conflicts of interest.
- Not accept benefits from third parties.
- Declare an interest in proposed transactions with the company.

There is currently debate in the UK around this definition of directors' duties and whether or not they should be codified in statute. In particular, the *'duty to promote the success of the company for the benefit of its members as a whole'* requires directors to have regard to long-term and wider factors affecting the company such as the interests of employees, suppliers, customers and the environment. This is referred to in the Company Law Reform White Paper as *'enlightened shareholder value.'*

Although the statutory duties are not intended to change the law, it is argued that codification in statute may create uncertainty about the duties and liabilities of directors. This may lead to confusion as to who directors are actually accountable to, even though it is recognised that first and foremost accountability is to the company itself.

1.2 The fiduciary duty of loyalty and securities regulation

A fiduciary duty concerns the legal relationship between a trustee (fiduciary) and a principal (beneficiary). A directors' duty of loyalty to a company relates to the position of trust bestowed on them as a director in acting in the best interests of the company. In doing so they must not put their personal interests before those of the company, must not secretly profit from their position and must not have a conflict of interest without it being disclosed.

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[7] 'Enforcement and Corporate Governance: Three views', *Focus 3*, Global Corporate Governance Forum, 2005, p. 6.

[8] Company Law Reform Bill, White Paper 2005, Department of Trade & Industry.

[9] Company Law Reform Bill, Part 10 – Company Directors, Clauses 155-161.

Directors' fiduciary duties were referred to by Sir Adrian Cadbury and Ira M. Millstein as follows:

'Boards worldwide should come to understand that they are fiduciaries for other people's money and are therefore bound to create operational management capable of producing what their shareholders value and who respect the rights of the corporation's investors. This fiduciary duty must inform every decision a board makes, and any process it employs to make those decisions. A full comprehension of this duty should aid in assuring efficient performance, preventing trouble before it occurs and ensuring respect for investors.' [10]

In the US, the duty of loyalty is described in the Model Business Corporation Act as follows:

'Each member of the board of directors…shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.' [11]

The most commonly recognised aspect of a directors' duty of loyalty arises in a self-dealing situation where a conflict of interest may occur. This relates to transactions a director may enter into with a company where he or she has a financial interest. Such transactions are commonly approved by the non-interested directors and, in the UK, the following key tests are considered:

- *'Is the transaction reasonably incidental to the carrying on of the company's business?*
- *Is it a bona fide transaction?*
- *Is it done for the benefit and to promote the prosperity of the company?'* [12]

Directors' duties of loyalty are often considered in cases of securities regulation. Under US federal law, judges decide on whether or not a breach of directors' duties has been committed under Federal Sentencing Guidelines.[13] In particular, directors are required to comply with disclosure obligations of the Securities Act 1933 related to public offerings governed by the SEC. Section 11 of the Act imposes strict liabilities on directors for material inaccuracies or omissions in registration statements or prospectuses.

On the secondary market, shareholders may allege a breach of a directors' duty of loyalty through fraud under Section 10-b and Rule 10-b5 of the Securities Exchange Act 1934. Under this provision, shareholders can allege that they either bought or sold shares on the basis of fraudulent information. The rules are intended to mitigate market abuse, including the misuse of information, creating misleading impressions to distort the market.

In the UK, the Financial Services Authority[14] has the power to impose unlimited civil penalties on companies and directors for breaches of the Listing Rules. It may withdraw the authorisation of a company from the Main Market and, in extremis, may bring criminal prosecutions through the courts.

Directors of companies listed on the Main Market are subject to regulation regarding insider dealing through Part V of the Criminal Justice Act 1993. They are also subject to regulation under Part VIII of the Financial Services and Markets Act 2000 for market abuse and can be liable for civil penalties. This includes misuse of information which is not generally available to the market and creating a false impression of the value of investments.

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[10] 'The New Agenda for the ICGN', Adrian Cadbury and Ira M. Millstein, International Corporate Governance Network, July 2005.

[11] Model Business Corporation Act, 8.30 (a), 1984.

[12] See *MacPherson v European Strategic Bureau Ltd* (2000), in *Mayson, French & Ryan on Company Law*, 21st Edition 2004-2005, Oxford University Press, p. 517.

[13] http://www.ussc.gov/guidelin.htm.

[14] http://www.fsa.gov.uk.

To mitigate violations under insider trading or market abuse regulations, directors are required to follow a Model Code which outlines the standard of behaviour and conduct expected of them. Companies are required by the Listing Rules from the United Kingdom Listing Authority to have a code of conduct which is the same standard as the Model Code. Directors may also be disqualified under the Company Directors Disqualification Act 1986 for between 2 and 15 years. Reasons for disqualification include a persistent failure to file accounts, fraudulent trading and conviction of an indictable offence.

In addition, a directors' duty of disclosure is becomingly widely recognised under company law in the US and the UK. This extends to any information about the directors themselves and any conflicts of interest they may have. The scope of the duty of disclosure was described by Professor Bernard S. Black in the US as follows:

'The scope of the disclosure obligation under company law is still evolving, but includes two core cases: when shareholders are asked to vote, and when the company completes a self-dealing transaction. For both, the disclosure obligation is framed in terms of an obligation not to omit or misstate material facts, where the standard for materiality is necessarily imprecise and fact-dependent.'

'The justification for full disclosure before a shareholder vote is obvious. Without good disclosure, the shareholders may not know how to vote. There are several justifications for requiring full disclosure of self-dealing transactions. First, the disclosure gives the shareholders the information that they need to sue, claiming a violation of the duty of loyalty. Second, disclosure, without more, will deter some self-dealing transactions from being completed and will cause the self-dealing transactions that are completed to be fairer to outside shareholders, on average and over time. Third, if a self-dealing transaction is concealed, and later discovered, it can be much easier to prove a violation of the duty of disclosure than to prove a breach of the duty of loyalty.'[15]

1.3 The duty of care and the US Business Judgment Rule

The duty of care requires directors to have the requisite competence to fulfil their responsibilities by acting on a fully informed basis and with due diligence. In this respect in the US, the Model Business Corporation Act states that:

'The members of the board of directors….shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.' [16]

The duty of care as described above is a standard of desired conduct, rather than a standard of liability. A breach of the duty of care is found if gross negligence is proven and the test for this is known as the Business Judgment Rule. The Delaware Supreme Court defined the rule as follows:

'The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish the facts rebutting the presumption.' [17]

The Business Judgment Rule is designed to protect directors in taking calculated business risks within their authority. A breach of a duty of care is rare in the US as the test is highly subjective – i.e. it is a general statement of assumed behaviour and ability. The courts tend not to intervene in a directors' ability to make decisions on behalf of the company.

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[15] 'The Core Fiduciary Duties of Outside Directors', Professor Bernard S. Black, Standford Law School, John M. Olin Program in Law and Economics, Working Paper No. 219, 2001.

[16] Model Business Corporation Act, 8.30 (b), 1984.

[17] *Aronson v Lewis*, 473 A.2d, 812 (Del. 1984).

An exception is in the case of *Smith v Van Gorkom*[18] in 1985 where directors were found to have violated their duty of loyalty after not giving due consideration to a company merger.

More recently in 2005, the Delaware Chancery Court heard the case of *The Walt Disney Company*[19] where directors were challenged on their decision to award the former CEO a severance package of $140 million. The court resolved the case in favour of the directors, absolving them from the alleged breaches of fiduciary duties. In contrast to the *Smith v Van Gorkom* decision, members of the board were provided with advance notices and other documentation which showed that they had observed due process in determining the remuneration award. They were therefore not considered to have shown deliberate indifference to their responsibilities as directors.

Professor Black summarised the duty of care in the US and the Business Judgment Rule in the following abstract:

'The duty of care is the duty to pay attention and to try to make good decisions. I often encounter surprise about how little the duty of care requires the directors to do. They do not have to make sensible decisions. They only have to show up, pay attention, and make a decision that is not completely irrational. American courts simply do not hold directors liable for business decisions, made without a conflict of interest, unless those decisions are completely irrational.

'The doctrine of non-interference is known as the Business Judgment Rule. It has several justifications. First, the courts are bad at second guessing in hindsight decisions that turned out poorly. Second, an investment in a business can turn out badly for a whole host of reasons. Bad management decisions are only one of these reasons. They are a risk that shareholders knowingly assume. Third, some risky decisions will work out wonderfully, while others will work out terribly. If the directors risk being found personally liable for bad outcomes, they will be reluctant to take risks, and we will get fewer really good decisions too.'[20]

1.4 The duty of care and the UK Insolvency Act 1986

Directors in the UK become liable for negligence when the duty of care has been breached, but in practice it is rarely contested. In the late nineteenth century, directors were generally appointed on the basis of their merit in society. When becoming a director they were not expected to apply knowledge, skill or experience to their board position. A breach of duty was difficult to prove as applying a standard of care was largely subjective, i.e. based on presumed knowledge, as expressed in *Re City Equitable Fire Insurance Co. Ltd*:[21]

'A director need not exhibit in the performance of his duties a greater degree of skill than may be reasonably expected from a person of his knowledge and experience.'

The subjective test, based on what was reasonably to be expected of a director, has evolved with increased recognition that directors are expected to have knowledge and skill relevant to the business. This is evident in the case of *Re Barings plc*[22] where it was stated that:

'Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them to properly discharge their duties as directors.'

However, it is generally thought that the subjective test is too lenient on its own and

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[18] *Smith v Van Gorkom,* 488 A.2d 858 (Del, 1985).

[19] *Re The Walt Disney Company Derivative Litigation*, Del. Ch., C.A. No. 15452, August 9, 2005.

[20] 'The Principal fiduciary duties of boards of directors', Professor Bernard S. Black, Presentation at Third Asian Roundtable on Corporate Governance, Singapore, 4 April, 2001.

[21] Romer J. in *Re City Equitable Fire Insurance Co. Ltd* [1925] Ch 407, p. 428.

[22] *Re Barings plc*, (No.5) [2000] 1 BCLC 523, at pp. 535-6.

an objective test i.e., actual knowledge, is becoming more widely accepted. The UK Insolvency Act 1986 has included both a subjective and objective judgement when considering a director's duty of care in relation to insolvency as follows:

'the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached, or taken, by a diligent person having both:

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in connection with the company; and

(b) the general knowledge, skill and experience that this director has.'[23]

1.5 Directors' liability

Risk is an integral part of business activity. The board needs to oversee the management of risk and legal standards, such as the Business Judgment Rule, serve to protect directors in taking decisions in the interests of the company. In efforts to maintain investor confidence since the corporate scandals earlier in the decade a number of new laws have been enacted or corporate governance codes updated.

In the US, the Sarbanes-Oxley Act 2002 increased the responsibilities on directors of SEC registrants with the introduction of new requirements. For example:

- Section 302 introduced requirements for disclosure controls and certification by the CEO and CFO of certain reports filed with the SEC; and

- Section 404 requires the assessment by management of the effectiveness of a company's internal controls over financial reporting as well as an attestation and report on management's assessment by the external auditor.

In the UK, response to corporate scandal is often in the form of strengthening comply-or-explain principles through the Combined Code on Corporate Governance (Combined Code). In 2003 the Code was revised based on two significant reports:

- a *Review of the role and effectiveness of non-executive directors* conducted by Sir Derek Higgs and commissioned by the Department of Trade & Industry and HM Treasury; and

- the *Guidance on Audit Committees* produced by Sir Robert Smith and commissioned by the Financial Reporting Council.

In the US, the use (or threat) of class action law suits, is increasingly used by shareholders as a mechanism to influence the governance of companies. In a class action, a shareholder brings a law suit against a company on behalf of other shareholders in the same class. This provides a mechanism to pursue financial compensation and around 200 class actions law suits are filed in federal courts every year.[24] However, companies are increasingly choosing to settle out of court as the following case exemplifies:

'In Pirelli Armstrong Tire Corp. Retiree Medical Benefits v. Hanover Compressor Company, et al (2004), plaintiffs accused Hanover of failing to disclose certain financial developments. Hanover settled the case without admitting or denying fault. As part of the settlement, Hanover agreed to several governance changes, including those that would give its institutional investors an automatic say in the nomination of directors.'[25]

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[23] Insolvency Act 1986, section 214 (4).

[24] 'Caution – D&Os Working: Reducing Liability Exposure in 2005', National Association of Corporate Directors, DM Extra, January 3, 2005.

The use of class action law suits is not common in the UK. This is primarily because the loser in a class action is liable for paying both his or her own legal fees as well as those of the defendant. This contrasts with the US position where, unless the class action was taken in bad faith, the loser is only liable for the legal costs they have incurred (though class counsel usually covers them) and not the defendants' fees. The difference between the two systems was described by Keith Johnson, chair of Reinhart Institutional Investor Services in the US, as follows:

'I believe that lack of contingency fees, existence of the "loser pays" system for UK legal fees, lack of an experienced segment of the UK bar devoted to bringing theses cases, and absence of some of the supporting legal, procedural rules that are present in the US are amongst the main differences'.[26]

In the UK the Company Law Reform Bill is proposing to introduce statutory derivative action rights, a current feature of common law. This would allow a shareholder to pursue a claim against a director through the courts on behalf of the company for negligence, default, breach of duty or breach of trust. The outcome of such an action is not intended to compensate the shareholders financially but to bring about governance changes for the best interests of the company. However, there are safeguards to prevent misuse, for example by halting actions that would be pursued by someone not acting in good faith to promote the success of the company.

An example of the more prevalent use by US shareholders of litigation to bring about governance changes, compared to their UK counterparts, is evident in the World Bank's *Doing Business Indicators* below. The indices provide a measure of business regulation and its enforcement and are are comparable across 155 economies. For example, regulation in respect of protecting investors is ranked for each country on a scale of one to ten, where one indicates a weak score and ten indicates a strong score. The indicators describe three dimensions of investor protection being:

(1) transparency of transactions (Disclosure Index);

(2) liability for self-dealing (Director Liability Index);

(3) shareholders' ability to sue officers and directors for misconduct (Shareholder Suits Index).

Table 2: Doing business indicators shareholder protection (2005)[27]

Indicator	United States	United Kingdom
Disclosure Index	7	10
Director Liability Index	9	7
Shareholder Suits Index	9	7

[25] 'Caution – D&Os Working: Reducing Liability Exposure in 2005', National Association of Corporate Directors, DM Extra, January 3, 2005.

[26] Email correspondence from Keith Johnson to the author, 12 May 2006.

The use of shareholder suits to bring about corporate governance changes in the US compared to other jurisdictions, may have adverse affects on the attractiveness of the US capital markets as highlighted by the Chairman of the NYSE, Marshall N. Carter:

'The US is losing listings because of the persistent concerns surrounding the US trial bar and the litigious environment in the US. We need to recognise that the United States today has the reputation, both at home and globally, as an increasingly difficult place to do business. The possibility of being sued for huge sums, while also bearing high costs of legal defence has brought many companies to a moment of reckoning that mitigates against registering their securities in the United States. The total value of settlements in securities litigation class action lawsuits has continued to increase from $150 million in 1997 to $9.6 billion in 2005. Given the risks and threats to their bottom line, regrettably, foreign companies are simply concluding that it's not worth it to come our market'.[28]

Recent focus on directors' fiduciary duties has increased the demand for liability insurance in both the US and the UK. In addition, the introduction of new laws and the perception of increased director liability is leading to higher remuneration for non-executive directors and a perception that individuals are less willing to serve on boards. This is echoed in research indicating that director pay is rising at 11% per year in the largest US companies[29] and the proportion of individuals declining invitations to join a board has more than doubled from 13% in 2002 to 29% in 2004.

[27] Doing Business: Explore Economics: Protecting Investors Report, The World Bank Group 2005.

[28] 'America's Capital Markets: Maintaining Our Lead in the 21st Century', Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, United States House of Representatives, Washington DC, April 26, 2006.

[29] 'Frontier Justice? Recent D&O Settlements Prompt Rugged Individualism and Calls for Realism', National Association of Corporate Directors, DM Extra, January 14, 2005.

2. Board structure and the role of non-executive directors

Both US and UK companies have a single, unitary board with a combination of executive and non-executive directors. The board's general leadership and management oversight role is similar between the two countries but differences often emerge in board dynamics. This is apparent in the balance of executive and non-executive directors, determinants of independence and the role of various board committees.

The *Pressure Points* consultation paper raises the following question:

Q11. How do differences in the relative roles and proportions of non-executive directors and executive directors in the US and the UK impact on company performance?

In considering this question, the following areas are relevant:

- The role and composition of the board.
- The effectiveness of non-executive directors.
- Board nomination practices.
- The role of the nomination committee.

2.1 The role of the board

In the UK, typically two-thirds of the board in the larger listed companies is comprised of non-executive directors who work collectively with their executive colleagues.[30] US boards are typically comprised almost entirely of non-executive directors with the addition of the CEO, and increasingly the CFO. It is common for audit, remuneration and nomination committees to be established in both countries.

In the US and the UK, directors are responsible for acting in the best interests of the company and are accountable to shareholders. The effectiveness of corporate governance is influenced by how directors interact and how they communicate with shareholders. The role of the board was described by SEC Commissioner Cynthia A. Glassman in her personal remarks at the 2005 ICAEW corporate governance roundtable in Washington DC:

'The directors' role in the corporate governance process includes several important components. First, the board must make sure the company has the right management leadership. The CEO is the board's agent, not vice versa. The board must make sure the CEO is accountable for his or her actions and that the CEO's compensation is appropriate. Next, the board must oversee the company's business strategy – kicking the tires to make sure its assumptions are realistic and that the company is on track to meet its strategic goals. In addition, the board monitors the performance of the company, focusing on both risk and return. The board must understand the drivers of performance and set the tolerance for risk. This covers oversight of operations, financial performance and reporting as well as regulatory compliance and risk management issues. Again, the overall goal of the governance structure and process is to maximize shareholder value through effective use of the firm's capital.'[31]

[30] KPMG Report, which found that the total number of FTSE 100 directors are made up of 445 executive directors and 708 non-executive directors, September 2004.

[31] Remarks of SEC Commissioner Cynthia A. Glassman at the ICAEW B*eyond the myth of Anglo-American corporate governance* roundtable, Washington DC, 6 December 2005.

2.2 The attributes of non-executive directors

Non-executive directors in both the US and the UK are relied upon to bring additional skills, knowledge and contacts to the board. They are challenged with rigorously questioning proposals from executives in the best interests of the company. Non-executive directors are perceived as active board members who are expected, not only to perform an oversight function, but also to contribute to the development of strategy. This is reflected in recommendations in the UK's Combined Code:

'As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.'[32]

In the UK, research conducted for the Higgs Report suggested that the role of the non-executive director should primarily be '*to create accountability through challenging, questioning, testing, probing, debating, advising and informing*.'[33]

The effectiveness of how non-executive directors fulfil their roles is often determined by the way the board functions (as reflected for example in the flow of information and the timeliness of meetings) and their relationships with executive management. However, personal qualities are also important. A recent study showed that effective non-executive directors are considered to be analytical, articulate, decisive, honest and dedicated. In contrast, some non-executive directors may not be as effective as their colleagues due to a lack of knowledge, or access to information, commitment or preparedness.[34]

2.3 Board nomination committees

Both the US and the UK have traditionally relied on informal networks to nominate board members, perpetuating a lack of diversity on boards. Findings from the Higgs Review in early 2003 highlighted that almost half of the UK non-executive directors surveyed were recruited to boards through personal contacts and only 4% had a formal interview. Likewise, in the US, a survey[35] by the National Association of Corporate Directors (NACD) found that fewer than 42% of boards used an executive search firm for recruiting board candidates.

There has been increased recognition of the importance of transparent and fair procedures for the appointment of directors. Independent nomination committees are considered integral to this process. In the US, NYSE and NASDAQ Listing Rules require boards to establish independent nomination committees which must have a written charter that addresses its purpose and responsibilities. The role of the nomination committee in both the US and the UK generally includes identifying and recommending board candidates, evaluating board composition, considering diversity and succession planning, and assessing the board's leadership requirements.

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[32] Combined Code on Corporate Governance, Principle A.1, Financial Reporting Council, 2003.

[33] 'Creating accountability within the board: The work of the effective non-executive director', Dr Terry McNulty of Leeds Business School, Dr John Roberts of the Judge Institute of Management and Dr Philip Styles of the University of Cambridge, 2002.

[34] 'The rise of the non-executive director', Roffey Park Institute, 2006.

[35] Public Company Governance Survey: 2003-2004', National Association of Corporate Directors.

The SEC now requires boards to disclose the nomination committee's practical role in identifying directors and how they take into account shareholder recommendations. In the UK, an explanation must be given in the annual report if neither an external search consultancy nor advertising has been used in the appointment of a non-executive director or a chairman.[36]

NYSE rules require the nomination committee to be comprised solely of independent non-executive directors while companies listed on NASDAQ are obliged to have a majority of independent non-executive directors. The UK approach, under the Combined Code, is similar to that of NASDAQ by recommending that a majority of independent non-executive directors comprise the nomination committee. The chairman (who is not considered independent after appointment) often sits on the nomination committee reflecting his or her important role in overseeing board composition, but is not expected to take part in discussions about his or her successor as chairman.[37]

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[36] Combined Code on Corporate Governance, Provision A.4.6, Financial Reporting Council, 2003.

[37] Combined Code on Corporate Governance, Provision A.4.1, Financial Reporting Council, 2003.

3. Leading the board

There is a distinct difference between the governance of US and UK companies in terms of board leadership, with the former generally combining the roles of the chairman and CEO and the latter generally separating the two. A successful leadership model however depends not just on the delineation of power, but the effectiveness of chairmanship and overall board dynamics.

The *Pressure Points* consultation paper raises the following question:

Q12. What are the key benefits and/or disadvantages of either separating or combining the positions of the Chairman and CEO?

In considering this question, the following areas are relevant:

- The reasons for separating the role of chairman and CEO in the UK.
- The role of the senior independent director in the UK.
- The role of the lead independent director in the US.

3.1 Separating the roles of the chairman and CEO in the UK

Since the publication of the Cadbury Code in 1992, an increasing number of UK listed companies have separated the role of the chairman and CEO. Today 93% of FTSE 350 companies separate the roles[38] and apply the following principle of the Combined Code:

'There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision-making.'[39]

In the UK, the chairman is typically responsible for leading and facilitating the board and encourages full, frank and open discussion between board members. The CEO is on an equal footing with his or her colleagues on the board who are collectively responsible for the company. The two perform very different functions – the chairman runs the board and the CEO runs the company.

In the UK, the chairman is expected to be independent on appointment. Under the Combined Code this includes not being the former CEO of the same company.[40] Today only 24% of FTSE 350 companies do not have a chairman who was independent on appointment.[41] In these cases, the reasons for non-compliance are explained to shareholders under the comply-or-explain approach which enables companies to explain to shareholders why they have departed from the Code's provision.

The benefits of separating the roles of the chairman and the CEO are considered to arise because of the specific responsibilities assigned to the chairman who, in the UK, is expected to:

- Provide guidance to the CEO, often with insights from past experience as a CEO.

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[38] Fourth FTSE 350 Corporate Governance Review, Grant Thornton, (note: review of 319 of the FTSE 350 companies), November 2005.

[39] Combined Code on Corporate Governance, Principle A.2, Financial Reporting Council, 2003.

[40] Combined Code on Corporate Governance, Provision A.2.2, Financial Reporting Council, 2003.

[41] Fourth FTSE 350 Corporate Governance Review, Grant Thornton, (note: review of 319 of the FTSE 350 companies), November 2005.

- Play a vital role in shaping the board's agenda and facilitate meetings. In practice, it is normally the CEO who proposes items for approval and it is therefore important that objective and constructive discussion is facilitated in an independent manner.

- Create an environment where open and frank discussion is encouraged. The chairman in the UK is expected to hold meetings at least once a year without the presence of executive management.

- Liaise with external organisations, shareholders and other stakeholders, who may wish to discuss an issue with someone other than the CEO of the company.

- Oversee the performance of executive management together with the other non-executive directors.

The position of chairman in the UK is highly regarded and is often seen as the pinnacle of a successful career. The average time contributed by the chairman to a FTSE listed company averages between 54 and 60 days a year for companies with an annual revenue of more than £100 million.[42] Annual remuneration for the services of a FTSE 100 chairman averages around £250,000.[43] Given this commitment, the Combined Code recommends that an individual should not be appointed to a second chairmanship of a FTSE 100 company.[44]

3.2 Clarifying the role of the senior independent director

In the UK, the appointment of a senior independent director (SID) has been recommended since the publication of the Combined Code in 1998 and today 83% of FTSE 100 companies have made such an appointment.[45]

The main responsibilities of the SID are to:

- Lead the meetings of non-executive directors, without the chairman present, at least annually to appraise the chairman's performance.

- Be available to shareholders if they have concerns which contact through the normal channels of chairman, CEO or finance director has failed to resolve or for which such contact is inappropriate.

- Attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of their issues and concerns.

3.3 Combining the role of the chairman and CEO in the US

In the US, 76% of the top 200 companies (by revenue) combine the roles of the chairman and the CEO. The remaining 24% report separating the roles but of this figure only 16% declare the chairman to be independent (not formerly the CEO).[46] This reflects the traditional and commonly held view that a single individual assuming the role of both chairman and CEO is a strength in promoting a clear strategy and enabling speed of decision-making.

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[42] 'The role and effectiveness of non-executive directors', The Higgs Report, 2002.

[43] 'The rise of the non-executive director', Roffey Park Institute, 2006.

[44] Combined Code on Corporate Governance, Provision A.4.3, Financial Reporting Council, 2003.

[45] 31st Annual Board of Directors Study, Korn/Ferry International, 2004.

[46] 'Directors compensation', Study of the Top 200 Corporations, Pearl Meyer & Partners, 2005.

The *Financial Times* recently reported reasons why many US companies prefer to combine the roles of the chairman and CEO with the following survey statistics:[47]

- 46% of respondents said that having a separate chairman and CEO invited power struggles;
- 44% said that strategy should be controlled by a single person; and
- 39% said succession planning was simpler if there was only one top job.

The traditional view of the role of the CEO in the US compared to a modern perspective was described by Arthur Levitt, former Chairman of the SEC:

'In the 1990s the typical CEO was the muscular individual, one of the Al Dunlops of the world who could acquire a company with the stroke of a pen, fire 20,000 employees six months later, sell the company as a misguided adventure a few years down the road, and receive a huge pay package as a sop to the conscience of the directors who had to acknowledge their original decision to hire him. The kind of CEO needed today, and the kind that generally follows a period of public disenchantment with the business community, is a CEO who is much more concerned with the public interest.'[48]

The NACD report on Board Leadership (2004) concluded that the separation of the chairman and the CEO roles is not in itself a requirement for effective board leadership and that board dynamics must also be taken into account. The report stressed the importance of independence and went on to say that:

'…we believe that there is a need for leadership to focus on the work of the independent directors. So, where the chairman and CEO roles are not separated, we believe that there should be a designated leadership role for an independent director to serve as a focal point for the work of all the independent directors, with clarity of role and continuity of who performs that role.'[49]

3.4 The emergence of the lead independent director in the US

In the US, there has been an increase in the appointment of a lead independent director (LID) to offset any potential concentration of power in any one individual on the board. Currently 36% of the top 200 companies appoint a LID annually and 28% rotate the position.[50]

This trend reflects NYSE Listing Rules which now require companies formally to appoint a LID. The board also should have regular meetings ('executive sessions') solely for non-executive directors without management present. This is designed to promote open and frank discussion, particularly around sensitive issues and provide an opportunity to discuss the performance of executive management. Furthermore, independent non-executive directors must also hold a meeting at least once a year.

The NACD report recommended that companies should have flexibility in determining board leadership through either: a single independent non-executive chairman; or a combined chairman and CEO role together with the appointment of a LID. The report went on to make the following recommendations around board leadership:

- A leader of the independent directors should be appointed by, and from, the independent directors of the board;

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[47] 'CEOs attracted by undiluted power', (report based on a survey conducted by Russell Reynolds Associates and Harris International) *Financial Times*, 2 February 2006.

[48] Corporate Culture and the Problem of Executive Compensation', Arthur Levitt, Jr., The Carlyle Group, *Journal of Applied Corporate Finance*, Volume 17, Number 4, Fall 2005, Morgan Stanley.

[49] 'Report of the Blue Ribbon Commission on Board Leadership', National Association of Corporate Directors, 2004.

[50] 'Directors compensation', Study of the Top 200 Corporations, Pearl Meyer & Partners, 2005.

- The respective roles of the company leader (typically the CEO) and the leader of the non-executive directors need to be clarified in writing;

- The leader of the independent directors should possess the appropriate qualities for the role and be someone who is respected by all directors and the company leader; and

- The selection of board leaders should be based on performance, and leaders should be evaluated regularly.

The role of the LID is similar, in part, to that of the chairman on UK boards. The LID is responsible for co-ordinating the activities of the independent directors and acts as a primary liaison between the independent directors and the CEO on sensitive issues. Many US investors support the appointment of a LID and the California Public Employees Retirement Systems (CalPERS) recommend that the LID should:[51]

- advise the chairman on developing a schedule of board meetings and assisting with the content of agendas;

- interview all board candidates and make recommendations to the board's nomination committee;

- advise on the timeliness and content of information to independent directors;

- assist the board in assuring compliance with corporate governance standards;

- evaluate, along with the other independent directors, the performance of the individual with the combined chairman and CEO position; and

- recommend individuals for committee membership to the chairman.

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[51] 'Lead Independent Director Position Duty Statement', Corporate Governance Core Principles and Guidelines: The United States, California Public Employees Retirement System (CalPERS).

4. The independence of non-executive directors

A large proportion of independent non-executive directors on a board is a common feature in both US and UK corporate governance. There are now two classes of non-executive director: those who are not executive management and are deemed to be independent in accordance with legal and regulatory guidelines; and those who are simply not executive management.

The *Pressure Points* consultation paper raises the following question:

Q13. Are independence criteria for directors different in substance between the US and the UK?

In considering this question, the following areas are relevant:

- Board composition and independence.
- Definitions of independence.
- Disclosure requirements around independence for dual-listed companies.

4.1 The Combined Code's recommendations

In the UK, the Combined Code calls for at least half of the board, excluding the chairman, to be comprised of independent non-executive directors[52] and almost 65% of FTSE 350 companies comply with the provision.[53] The criteria which determine whether or not an individual is independent are outlined in the Combined Code:

UK Combined Code on Corporate Governance
Board balance and independence (Code Provision A.3.1)

'...The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- *Has been an employee of the company or group within the last five years;*
- *Has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;*
- *Has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;*
- *Has close family ties with any of the company's advisors, directors or senior employees;*
- *Holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;*
- *Represents a significant shareholder; or*
- *Has served on the board for more than nine years from the date of their first election.'*[54]

[52] Combined Code on Corporate Governance, Provision A.3.2, Financial Reporting Council, 2003.

[53] 'Fourth FTSE 350 Corporate Governance Review', Grant Thornton, (note: review of 319 of the FTSE 350 companies), November 2005.

[54] Combined Code on Corporate Governance, Provision A.3.1, Financial Reporting Council, 2003.

While many companies in the UK follow the independence criteria in the Code, the comply-or-explain nature of the Combined Code allows for departures from the criteria. Shareholders often accept the need for flexibility in recognition that no two companies are the same. For example, while there is a requirement for non-executives to have served for no more than nine years in order to be determined independent, there can be flexibility on this recommendation. On occasion non-executive directors serving more than nine years may be considered to be independent in character and judgement by the board. In this regard, independence is often considered a 'state of mind' determined by personal characteristics, rather than by compliance with stringent rules.

4.2 Tests under NYSE Listing Rules

In the US, NYSE and NASDAQ Listing Rules require companies to have a majority of independent directors on the board and encourage non-executive directors to meet on a regular basis without management present. The proportion of directors complying with independence criteria in the US is highlighted in the following statistics from the NACD:

Table 3: Board independence in US publicly listed companies[55]

Board make-up	2000	2001	2003
> $^1/_2$ independent	54%	61%	74%
> $^3/_4$ independent	28%	29%	34%

The NYSE criteria for defining the independence of non-executive directors are as follows:

NYSE Listing Rules
Independence Tests (Rule 303A.02 (b) (V))

(a) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must identify which directors are independent and disclose the basis for that determination.

(b) In addition, a director is not independent if:

(i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer, of the listed company.

(ii) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $100,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

[55] 'Public Company Governance Survey: 2003-2004', National Association of Corporate Directors.

(iii) *(A) The director or an immediate family member is a current partner of a firm that is the company's internal or external auditor; (B) the director is a current employee of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or (D) the director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the listed company's audit within that time.*

(iv) *The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.*

(v) *The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.*

In addition in the US, audit committees must be entirely independent under Section 301 of the Sarbanes-Oxley Act. Furthermore, a company must disclose in its proxy statement whether members of the nomination committee are independent.[56]

4.3 Contrasting requirements for dual-listed companies

Disclosure of information to shareholders is an integral part of both the US and UK corporate governance systems. In the UK, the names of the directors determined to be independent *'in character and judgement'* must be disclosed in the annual report.[57] In the US the SEC has proposed rules related to the disclosure of independent directors in registration statements.[58]

Companies listed in more than one jurisdiction can sometimes face difficulties in meeting disclosure requirements around independence due to conflicting standards. For example, an individual is generally not considered to be independent in the UK, according to the Combined Code, if they have been an employee within the past five years while in the US, under NYSE requirements, the relevant period is three years.

It is a common requirement for companies with foreign listings to disclose publicly how the domestic standards with which they comply differ from those of the country of listing. As an example, the following extract is provided by BP plc, a UK registered company which is also listed on the NYSE:

'BP has adopted a robust set of Board Governance Policies, which reflect the UK's prevailing principles-based approach to corporate governance. As such, the way in which BP makes determinations of directors' independence differs from the NYSE rules. NYSE Rule 303A.02 sets out five bright line tests for director independence. In addition to these five tests, the NYSE also requires that the board of directors "affirmatively determines that the director has no material relationship with the company (directly or as a partner, shareholder or officer of an organization that has a relationship with the company)".'

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[56] SEC Release No. 33-8340; 34-48825.

[57] Combined Code on Corporate Governance, Provision A.3.1, Financial Reporting Council, 2003.

[58] 'Executive compensation and related party disclosure', SEC, January 27, 2006.

'BP's Board Governance Policies require that all non-executive directors be "free from any business or other relationship with the executive management of the Group which could materially interfere with the exercise of their independent judgment". The BP Board has determined that, in its judgment, all of the non-executive directors are independent. In doing so, however, the Board did not explicitly take into consideration the NYSE's five bright line tests.' [59]

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[59] NYSE Corporate Governance Rules, www.bp.com.

5. Rewards and performance

High levels of executive remuneration ('compensation') are a concern in both the US and the UK. The use of share options has been considered a major contributing factor to corporate scandals involving accounting fraud. As a result, governments have strengthened disclosure regulations and institutional investors in both countries engage with companies on pay-related matters including levels of remuneration, length of service contracts, use of share options and performance conditions.

The *Pressure Points* consultation paper raises the following questions:

Q14. To what extent is it seen as feasible or desirable in the US and the UK for levels of remuneration to be influenced by investors or regulated by governments?

Q15. Is company performance enhanced if non-executive directors are compensated with stock options or other performance-related incentives?

In considering these questions, the following areas are relevant:

- Level and make-up of executive and non-executive remuneration.
- Performance related pay.
- Role and composition of the remuneration committee.
- Disclosure and accountability to shareholders.

5.1 Level and make-up of executive remuneration

In the US and the UK, executive remuneration is usually comprised of a basic salary, annual bonus, long-term awards (often including share options), pension contributions and perks. In determining remuneration to attract and retain directors, it is common practice to compare the market rate of pay with the level of pay in companies of similar size and industry. However, this can lead to an upward spiralling of remuneration causing salary inflation rates much higher than for the average employee. For example, in 1970, average remuneration for a US CEO of a listed company was just over 25 times that of the average worker. In 2003 it was 360 times as much.[60]

In the US, average total remuneration for a CEO of an S&P 500 company is higher than that at FTSE 100 CEOs in the UK according to a *Wall Street Journal* report. The report went on to say that in the US compensation packages rose more than 13% in 2004 according to the Corporate Library. This compares to an average rate of increase in the UK of 5.9% in 2005.[61]

Public tolerance of high levels of pay may differ between the US and the UK. Antipathy to 'fat cat' salaries is typical of UK society, encouraged by criticism in the press. US views on high salaries are described below by Dan Konigsburg:

'On the other hand, until recently, very high levels of executive pay have not been as controversial [compared to the UK] in the United States. Options were pointed to as the force driving the internet revolution and making the economy more competitive. Markets swooned to star CEOs who could drive companies from rags to riches single-handedly. Much of this has not survived the bubble and the accounting scandals. But much of it remains. There is still an idea that someone who creates $100 billion in value for shareholders should not be begrudged a mere $1 billion reward.'[62]

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[60] 'CEO: (n) greedy liar with personality disorder,' *Financial Times*, 2 July 2003.

[61] 'No Excessive Pay, We're British,' *Wall Street Journal*, 8 February, 2006, p. C1.

[62] 'Similarities and Differences in the United States and United Kingdom,' D. Konigsburg, in *Governance and Risk* (G. Dallas, ed.), ch. 16-3, New York, McGraw-Hill, 2004, © The McGraw-Hill Companies, Inc.

The more prevalent use of share options in the US may explain the difference in pay levels between US and UK executives. A 2004 survey[63] by Korn/Ferry International found that 20% of directors reported that the use of share option plans had been decreased or eliminated, while 45% reported increased (or first time) use of restricted shares.

Benchmarking executive pay against the industry average is now considered just one measure of determining awards. A report published by the ICAEW[64] into FTSE 350 directors' pay found that the top five influencers on the level of remuneration were:

1. company size;
2. shareholder returns;
3. company profitability;
4. individual directors' experience and qualifications; and
5. investors' views.

Some of the difficulties in determining the make up of remuneration in the US were described by Professors T. Baums and K. Scott in an article appearing in Morgan Stanley's *Journal of Applied Corporate Finance* as follows:

'Performance measures generally fall into two types: accounting based and stock based. Neither is free from serious defects. Accounting numbers are subject to substantial manipulation by top management, within GAAP rules as well as in violation of them, as recent cases have exemplified. Stock prices reflect general trends in the economy, up or down, for which management is not responsible and deserves neither credit nor blame.

In terms of the type of plan, again there are two broad categories: payment in cash and payment in stock or stock options. They differ in tax treatment and in accounting treatment and the rules can become intricate and beyond our level of detail. But there is a problem that cuts across all types, and that is the time period required for the executive to reap the full benefit. If there is immediate full ownership (so that the bonus cash can be spent or, when the option is exercised, the stock can be immediately sold) and the amounts are large, executives may be tempted to take steps to boost near-term profits at the expense of longer-term value or, in the extreme, to manipulate financial reports. This seems to be an important part of the explanation for recent cases like Enron, WorldCom and Tyco.' [65]

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[63] 31st Annual Board of Directors Study, Korn/Ferry International, 2004.

[64] *The determination of directors' remuneration in UK listed companies*, Ruth Bender, Institute of Chartered Accountants in England & Wales, 2003.

[65] 'Taking shareholder protection seriously? Corporate Governance in the US and Germany', Theodor Baums, University of Frankfurt and Kenneth E. Scott, Stanford Law School and the Hoover Institution', *Journal of Applied Corporate Finance*, Volume 17 Number 4, Fall 2005, Morgan Stanley.

5.2 Incentivising non-executive directors

In both the US and the UK, non-executive directors' fees have risen over the years in line with increased time demands and potential liability exposure. The benefits and drawbacks of joining a board as a non-executive director were summarised as follows in a recent UK report:[66]

Table 4: Benefits and drawbacks of board membership

Why join a board?	Why not join a board?
• opportunity to 'rub shoulders' with more experienced people; • believing in the organisation and its thinking; • 'putting something back' and recycling experience; • gain insights into other companies; • opportunity to contribute more broadly in one's own area of expertise.	• increased responsibilities and related potential risks; • time requirements; • lack of information about recruitment; • not being 'networked' with the 'right people'; • unwillingness of recruiters to consider non-plc experienced individuals.

In the UK, non-executive director remuneration is comprised mainly of an annual fixed fee and averages around £42,000 annually for a FTSE 100 board position. This is an increase of 21% from the period from January 2004 to March 2005.[67] In 2003, only two FTSE 250 companies offered share options to non-executives and just nine companies paid them partly in shares.[68] This reflects a general belief that conflicts of interest arise if those who are setting targets for management also benefit if those targets are achieved or exceeded.

The make-up of remuneration for non-executive directors in the US is generally higher than levels for their UK counterparts. The average US remuneration for non-executive directors of the top 200 companies (by revenue) is $182,300 annually. US non-executive directors are often paid with share options on the basis that they will be more effective if they have a personal stake in the company's success. Share option plans for non-executive directors must be approved by shareholders. A recent survey[69] of US directors of publicly quoted companies found that:

- 94% of respondents thought that (non-executive) directors should be rewarded with cash and shares;
- only 3% believed that directors should be paid in cash alone; and
- only 3% thought that director remuneration should be entirely in shares.

[66] 'The rise of the non-executive director', Roffey Park Institute, 2006.

[67] 'The rise of the non-executive director', Roffey Park Institute, 2006.

[68] Watson Wyatt survey of 90 FTSE 250 companies.

[69] Public Company Governance Survey: 2003-2004, National Association of Corporate Directors.

However, the popularity of share options is declining with recent statistics indicating the proportion of directors being awarded share options declining from 63% in 2003 to 51% in 2005.[70] This may not reflect disquiet with the principle of rewarding non-executives with share options so much as a concern about the impact of share options on earnings per share as a result of Financial Accounting Standards Board requirements for options to be expensed.

5.3 Performance factors and measures

While there are different perceptions on the acceptable level of executive salaries, there is sometimes common discontent on both sides of the Atlantic around misalignment between pay and performance. Today, with more transparent procedures and innovative performance measures, remuneration is based more on individual contribution than industry averages. It is now considered best practice for a high proportion of executive remuneration to be aligned to company performance. In the UK, 87%[71] of FTSE 350 companies comply with the Combined Code recommending that:

'The performance related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels.'[72]

The NYSE also recognises the importance of performance related pay measures in its Listing Rules:

'In determining the long-term incentive component of CEO compensation, the committee should consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in the past ten years.'

In their updated policy in 2005, the Council of Institutional Investors in the US emphasised performance measures over the long-term and increased transparency in reporting of compensation. In the same year in the UK, the Association of British Insurers published revised guidelines on executive remuneration and the National Association of Pension Funds published its 2004 Corporate Governance Policy which included best practice on developing remuneration policy.

In a study[73] determining why performance related pay (PRP) was important, the following factors were highlighted:

1. **To motivate executives:** views were mixed as to whether PRP actually motivated performance at a senior level and other factors such as a sense of achievement are equally important.

2. **A symbol of a chief executive's worth:** executives felt that PRP was important as a symbol of success rather than in monetary terms. Large bonuses can gratify executives' self-esteem in relation to their peers.

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[70] 'Directors compensation', Study of the Top 200 Corporations, Pearl Meyer & Partners, 2005.

[71] Fourth FTSE 350 Corporate Governance Review, Grant Thornton, (note: review of 319 of the FTSE 350 companies) November 2005.

[72] Combined Code on Corporate Governance, Principle B.1.1, Financial Reporting Council, 2003.

[73] *The determination of directors' remuneration in UK listed companies*, Ruth Bender, Institute of Chartered Accountants in England & Wales, 2003.

3. **Providing a focus:** PRP was viewed as being effective in helping to align the strategy of the company as set by the board with the individual performance of the CEO in achieving that strategy.

4. **Fairness:** respondents felt that it was fair that individuals who performed well were paid more than those who did not.

5.4 Role and composition of the remuneration committee

In the past in the US and the UK, decisions regarding executive remuneration were largely influenced by management with little oversight by non-executive directors. Today, remuneration committees are the primary mechanism by which the level and make-up of executive pay are determined.

In the US, NYSE Listing Rules[74] require remuneration committees to consist solely of independent directors, while NASDAQ[75] allows for a degree of flexibility but requires a majority of the members to be independent. The role of the remuneration committee was described by the Conference Board in the US as follows:

'Companies should have a remuneration committee composed entirely of independent directors. The committee should have the primary responsibility for ensuring that the company's executive remuneration programmes, including values transferred to management through cash pay, shares, and share-based awards, are fair and appropriate to attract, retain and motivate management, and are reasonable in view of company economics and the relevant practices of comparable companies. Consultants who provide recommendations for management compensation, including CEO remuneration, should have their primary reporting responsibility to the committee.'[76]

In the UK, the Combined Code recommends that the remuneration committee be comprised solely of independent directors.[77] However nearly 30% of FTSE 350 companies choose to explain their non-compliance with the relevant Code provision.[78] Non-compliance arises mainly because there is a preference for the chairman, who is not considered to be independent once appointed, to sit on the committee. Nevertheless, many UK companies see the chairman as playing a pivotal role in evaluating the performance and remuneration of board members and, in particular, the executive directors.

In response, the UK Financial Reporting Council (FRC) is considering possible amendments to the Combined Code. These would allow the chairman to sit on the remuneration committee, provided he or she is considered independent at the time of appointment. As part of a review by the FRC of the implementation of the Combined Code, it was found that institutional investors also support the chairman sitting on the remuneration committee:

'The Chairman may often be invited to attend remuneration committee meetings without being a member. This reflects the contribution that the chairman can bring to remuneration issues. A change to the Code to permit membership of the chairman would be appropriate if the standard of independence was met on appointment. This would be particularly relevant for smaller companies where the number of non-executive directors is more limited.'[79]

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[74] NYSE Listing Rule 303A (5).

[75] NASDAQ Listing Rule 4350 (c) (3).

[76] *Corporate Governance Handbook 2005: Developments in Best Practices, Compliance and Legal Standards*, p. 43, The Conference Board.

[77] Combined Code on Corporate Governance, Provision B.2.1, Financial Reporting Council, 2003.

[78] Fourth FTSE350 Corporate Governance Review, Grant Thornton (note: review of 319 of the FTSE 350 companies) November 2005.

[79] 'Review of the 2003 Combined Code: Summary of responses to the review', Financial Reporting Council, January 2006.

5.5 Disclosure and accountability to shareholders

In the UK, companies listed on the Main Market of the London Stock Exchange are obliged to follow the Directors' Remuneration Regulations 2002 (DRRR).[80] In June 2003, the Department for Trade & Industry published a consultation into how executive remuneration packages take into account performance measures when directors' contracts are terminated.[81] Subsequent research into the impact of the DRRR found that the regulations had had a positive impact on the alignment of executive rewards and performance measures and that no further changes to company law would be required.[82] Furthermore, the Combined Code encourages remuneration committees to: *'carefully consider what compensation commitments their directors' terms of appointment would entail in the event of early termination.'*[83]

Under the DRRR shareholders in the UK have the right to approve the remuneration policy recommended by the remuneration committee through an advisory vote. While the vote is non-binding it can send strong signals to the board about the perceived appropriateness of remuneration levels and performance targets. Companies listed on the Main Market of the London Stock Exchange must include a detailed report on directors' remuneration in the annual report and accounts. It must be distributed to shareholders and put to a vote at the annual general meeting. The report must include details of:

- the remuneration committee;
- a forward looking policy statement including:
  - performance criteria for long-term incentives and share options;
  - comparator groups;
  - duration of contract periods;
- performance graphs over a five-year period; and
- service contracts and compensation.

In addition, in the UK the Listing Rules of the United Kingdom Listing Authority require a remuneration report including:

- a policy statement;
- details on each director's package;
- share option information;
- long-term incentives details;
- service contracts; and
- pension rights.

[80] 'Rewards for Failure: Directors' Remuneration – Contracts, Performance and Severance', Department of Trade & Industry, June 2003.

[81] Schedule 7A, Companies Act 1985.

[82] 'Report on the impact of the Directors' Remuneration Report Regulations', Research conducted by Deloitte and Touche LLP on behalf of the Department for Trade & Industry, November 2004.

[83] Combined Code on Corporate Governance, Provision B.1.5, Financial Reporting Council, 2003.

The Combined Code also recommends shareholder approval of remuneration in relation to long-term incentive schemes as defined by the Listing Rules.[84] In particular, share-related incentive schemes which may influence the value of earnings per share are a matter for shareholder approval.

While in the US there is no requirement similar to the UK's DRRR, shareholder approval is required through a number of measures on share option plans as described by Professor J. Gordon:

'Companies put plans to shareholder vote for various regulatory and corporate law reasons. For example, Section 162(m) of the Internal Revenue Code requires shareholder approval of a stock option plan that would be regarded as "performance based" and so outside the $1 million deductibility cap on executive compensation. Section 303A.08 of the NYSE listing standards (and the parallel NASDAQ rule) require a shareholder vote on all "equity based compensation plans and material revisions thereto". From a corporate law perspective, some states require shareholder approval of stock option plans.'[85]

In the US, the SEC, together with the NYSE and NASDAQ, require remuneration committees to produce a report to be included in the company's annual proxy statement or annual report. Under the rules, remuneration committees must have a charter which discloses its purpose and includes committee member qualifications, structure and operations.

US companies are also required by the SEC to disclose the names and remuneration of directors in their regulatory filings. However information on total remuneration has generally been ambiguous and not always linked to performance. To address this, the SEC is proposing strengthening this disclosure with new rules.[86] Specifically, these would include a requirement for companies to provide a total remuneration figure for executives, as well as a new report describing how remuneration plans are structured and implemented. The SEC has consulted on proposals and plans to implement changes by the start of the proxy season in 2007. Commenting on the proposals the Chairman of the SEC Christopher Cox said:

'Executive compensation is much in the news and there have been some very notorious cases of apparent excess. It should be, of course, in the main up to shareholders to discipline that kind of activity, but in order for shareholders to do that, they have got to have good information. I think you can look in the near future to the SEC for some improved rules on disclosure to make sure that, for example, shareholders can have one number, that the different kinds of executive compensation add up to a number that's comparable executive to executive and company to company and at the same time that this information is provided in a timely way before rather than after the fact.'[87]

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[84] Combined Code on Corporate Governance, Principle B.2.4, Financial Reporting Council, 2003.

[85] 'A remedy for the executive pay problem: the case for Compensation Discussion and Analysis', Jeffrey N. Gordon, p. 33 Columbia University.

[86] 'Executive compensation and related party disclosure', SEC, January 27, 2006.

[87] 'Nightly Business Reports', Public Broadcasting System (August 10, 2005) as reported in 'New Executive Compensation Disclosure Rules in 2006', DM Extra, National Association of Corporate Directors, December 2005.

Useful contacts

United Kingdom

Accounting Standards Board – www.frc.org.uk/asb

Association of British Insurers – www.abi.org.uk

Auditing Practices Board – www.frc.org.uk/apb

Bank of England – www.bankofengland.com

Companies House – www.companieshouse.gov.uk

Confederation of British Industry – www.cbi.org.uk

Department of Trade & Industry– www.dti.gov.uk

Financial Reporting Council – www.frc.org.uk

Financial Reporting Review Panel – www.frc.org.uk/frrp

Financial Services Authority – www.fsa.gov.uk

Her Majesty's Treasury – www.hm-treasury.gov.uk

Hermes Pensions Management Ltd – www.hermes.co.uk

Institute of Chartered Accountants in England & Wales – www.icaew.co.uk

Institute of Chartered Secretaries and Administrators – www.icsa.org.uk

Institute of Directors – www.iod.com

Investment Management Association – www.investmentuk.org

London Stock Exchange – www.londonstockexchange.com

National Association of Pension Funds – www.napf.co.uk

Pensions & Investment Research Consultants Limited – www.pirc.co.uk

United States

American Bar Association – www.abanet.org

American Institute of Certified of Public Accountants – www.aicpa.org

American Stock Exchange – www.amex.com

Business Roundtable – www.brtable.org

CalPERS – www.calpers.ca.gov

Caux Round Table – www.cauxroundtable.org

Conference Board – www.conference-board.org

Corporate Library – www.thecorporatelibrary.com

Council of Institutional Investors – www.cii.org

Financial Accounting Standards Board – www.fasb.org

Global Proxy Watch – www.davisglobal.com

Governance Metrics International – www.governancemetrics.com

Institutional Shareholder Services – www.issproxy.com

Investor Responsibility Research Consultancy – www.irrc.org

NASDAQ – www.nasdaq.com

National Association of Corporate Directors – www.nacdonline.org

National Association of Securities Dealers – www.nasd.com

National Association of State Boards of Accountancy –www.nasba.org

New York Stock Exchange – www.nyse.com

Public Company Accounting Oversight Board – www.pcaob.org

Securities and Exchange Commission – www.sec.gov

Securities Lawyer's Deskbook – www.law.uc.edu/CCL

TIAA-CREF – www.tiaa-crefinstitute.org

International

Commonwealth Secretariat – www.thecommonwealth.org

European Commission – http://ec.europa.eu/index_en.htm

European Corporate Governance Institute – www.ecgi.org

Global Corporate Governance Forum – www.gcgf.org

Global Reporting Initiative – www.globalreporting.org

International Accounting Standards Board – www.iasb.org

International Corporate Governance Network – www.icgn.org

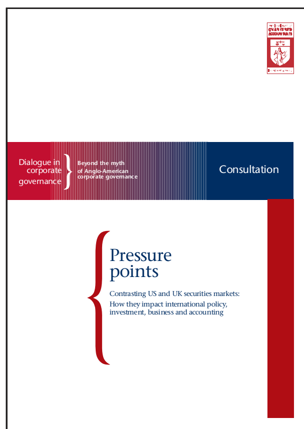
International Finance Corporation – www.ifc.org

International Monetary Fund – www.imf.org

Organisation for Economic Co-operation and Development – www.oecd.org

World Bank Group – www.worldbank.org

Pressure Points consultation and other discussion papers

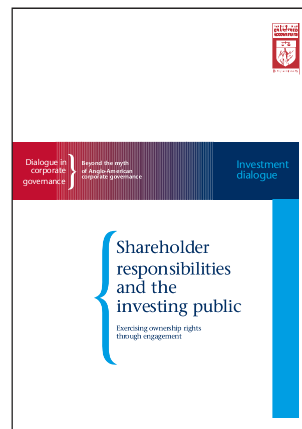


Pressure Points: Contrasting US and UK securities markets: How they impact international policy, investment, business and accounting

Discussion around the similarities and differences between US and UK systems of corporate governance challenges the commonly held presumption of an Anglo-American model. This consultation paper summarises key questions around how policy makers encourage business and investor confidence; how companies are directed and controlled and how disclosure and reporting requirements are framed and enforced.

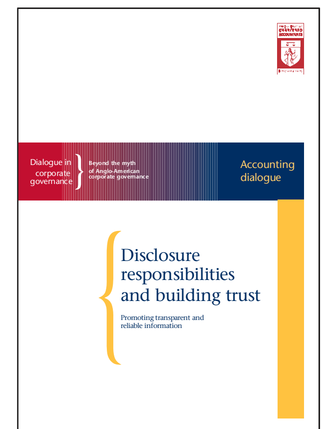
Policy dialogue:
Effective corporate governance frameworks – encouraging enterprise and market confidence

Effective corporate governance frameworks promote prosperity, market confidence and public trust. The US and the UK are amongst the world's most successful economies, each with a strong tradition of corporate governance. This paper explores how policy makers are challenged with striking the right balance between market forces and regulation in supporting internationally recognised corporate governance principles of responsibility, accountability, transparency and fairness.



Investment dialogue:
Shareholder responsibilities and the investing public – exercising ownership rights through engagement

Institutional investors play a significant role in the governance of companies in the US and the UK. They are the guardians of other people's money through the management of pensions, insurance and savings products and are expected to act responsibly in exercising their ownership rights. This paper explores the role of shareholders in corporate governance and their rights and responsibilities.



Accounting dialogue:
Disclosure responsibilities and building trust – promoting transparent and reliable information

The disclosure of meaningful, reliable and timely information to shareholders is of fundamental importance for informed investment decision-making and market confidence. High levels of financial disclosure are characteristic of both US and UK corporate governance models. This paper explores the role of the accountancy profession in helping to facilitate the flow of capital through transparent, efficient and trusted information.

Dialogue in corporate governance

Chartered Accountants' Hall PO Box 433 Moorgate Place London EC2P 2BJ
Tel 020 7920 8100 **Fax** 020 7638 6009 **www.icaew.co.uk**

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