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The Normative Evolution of Corporate Governance in the UK: An Empirical Analysis (1995-2014)

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Abstract

The UK is at the leading edge of development in modern regulatory corporate governance as a complement to company law. It is observed that the UK follows a shareholder primacy, or Anglo-American corporate governance model prioritising shareholder interests over other stakeholders. Several qualitative studies asserted the UK's position at the forefront of shareholder primacy corporate governance, however, this is the first article which specifically examines the key twenty year period from 1995 -2014 to track changes in UK corporate governance norms against the OECD recommended principles of corporate governance in the context of financial market growth. Specifically, we present a qualitative analysis of the major normative change points in UK corporate governance before assessing the impact of these structural changes in UK corporate governance on financial market growth. This will be achieved by quasi-empirical analysis comparing normative change points empirically, followed by a more traditional structural model. We find that compared to the OECD model of corporate governance, UK corporate governance is less rigid and follows a more self-regulatory approach, based upon a 'comply or explain' model and as such, scoring below countries following compulsory implementation models. Uniquely however, even with such 'low' tilt towards *formal* shareholder primacy norms - the UK has the best performing financial market. As a quasi-empirical study we posit that several historical and economic reasons with a robust rule of law in the UK - contribute to such a performance – and the law especially the type or tilt is less relevant.

Keywords: *Empirical corporate governance, shareholder primacy, comparative law, law and financial development, corporate governance evolution, financial market growth*

Introduction

Simplistically, corporate governance concerns the separation of functions between a company's board of directors and the annual general meeting (AGM) of shareholders or stakeholders. It concerns itself with the balance of power as between the directors at a managerial level, and the shareholders or stakeholders, whose involvement in the company may represent direct or indirect investment through electoral functions. At the most basic level, any division between ownership/investment, and control prompts the risk observed by Smith (1838)[1]: 'the directors of such companies [joint stock companies] however being the managers rather of people's money rather than of their own, it cannot be expected that they should watch over it with the same anxious vigilance [as if it were their own]'. The focus of this discussion is to consider how corporate governance has evolved normatively in the UK, benchmarked against the OECD Principles of Corporate Governance 2004, and to provide a quasi-experimental analysis to discuss its impact upon financial market growth.

It is perhaps surprising, in hindsight, that the interest in corporate governance largely represents a *reactive* response, prompted by the catalogue of high impact corporate events from the mid 1990's onwards - highlighted in the UK by the 1995 collapse of Barings Bank, but followed globally by Enron, Royal Ahold, Parmalat, HIH, China Aviation Oil, etc. This is not to suggest that the UK had no means of assuring confidence in the shareholder's position before this time, but rather that the previously relied upon assumptions of the 'traditional corporate governance model' proved to be dramatically inadequate and gave rise to significant questions. In other words, the basic convictions that UK corporate governance had rested upon for so long, that annual reports and audited accounts would provide sufficient confidence and protection for shareholders/stakeholders proved to be too simplistic and perhaps naïve in some instances.

UK corporate governance evolution and development is characterised by the dominant conception of 'shareholder value' widely prevalent in Anglo-American corporate governance, and thereby largely reflective of an agency theory perspective. Simplistically, as reflected by the pioneering research conducted by *Berle* and *Means* (1932)[2], pertaining to the separation of ownership and control, the corporate managers are placed in the role of an agent, with the shareholder as principal. The primary managerial focus of directors is rooted in 'fiduciary duty', serving the interests of the company by reflecting the interests of current and future shareholders. Corporate governance in the UK has, therefore, traditionally concerned itself with a rather narrow perspective focusing on the relationship between board members, management, and shareholders, in contrast with some jurisdictions, particularly Germany and Japan, where the function of corporate governance has traditionally addressed the interests of a wider range of stakeholders.

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[1] Adam Smith, *The Wealth of Nations* (first published 1776, W. Strathan and T. Cadell 1838) 574

[2] A Berle and G Means, *The modern Corporation and Private Property* (The Macmillan Company, 1932)

Whilst the foundations of UK corporate governance in the 21st century can be viewed as emerging from the acceptance of the corporate model as a vehicle for wider commercial growth in the 19th century, the focus and scrutiny of the last 25 years activated a structural and normative evolution in governance which continues to rely largely on a regime of self-regulation balanced with statutory guidance. The impetus for such scrutiny emanated from general global commercial growth (typified in the UK by non-familial shareholder investment), the influence of EU harmonisation, OECD recommendations, and perhaps (more significantly) the series of domestic and global economic corporate shocks beginning with Barings and Enron. This article explores the normative evolution of UK corporate governance, considering its impact on the basic assumptions of the UK's 'shareholder value' stance within the Anglo-American position in order to assess its *role* in the context of a company's performance on the UK financial market and financial market development and growth more generally. Firstly we quantify the 2004 OECD Principles into fifty-two individual variables. Secondly we analyse how these factors have evolved in the UK between 1995 and 2014. Thirdly, we create an index to chart the development of UK corporate governance in relation to the OECD principles. Fourthly we complement our empirical study by referencing: the position which preceded the period of corporate shock; an overview of the initial Combined Code (1998) growing from the Cadbury, Greenbury and Hampel reports; The Combined Codes (2003, 2006 and 2008); The impact of the Companies Act 2006; the OECD and EU influence; as well as the 2014-2015 Review of the OECD Principles of Corporate Governance, which resulted in the G20 Principles of Corporate Governance demonstrating a greater possible future attunement towards a more enlightened shareholder value (ESV). Finally we merge and graphically visualize the previously discussed UK normative corporate governance development change points with UK financial market development change points before concluding the article.

Review of Literature

Researching *effective* corporate governance mechanisms [3] and associated developments such as attributable performance parameters in global and domestic financial markets is increasingly at the centre of academic discourse. Controversially, much of the early scholarly debates on corporate governance functionality adopted monistic perspectives. That means, despite corporate governance developments paralleling dynamic, highly complex, systemic changes such as the proliferation of financial market integration and the emergence of legal transnationalism, scholars predominantly adopted and presented singular, generalist viewpoints. Hence, as a result of systematic corporate governance analysis being a relatively 'young' academic research discipline, existing work can often be characterised as being *intra-* instead of

[3] Corporate governance mechanisms defined as 'base' structural elements in reference to the four basic categories set out by Jensen (1993) 1. Legal and regulatory mechanisms, 2. Internal control mechanisms, 3. External control mechanisms, 4. Product market competition; in Michael C. Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems' [2003] The Journal of Finance 831

*inter*disciplinary, therefore only offering partial, incomplete and static[4] insight, which we identify to be a serious contentual deficit in present literature.

Since the early days of corporate governance research the composition of global and domestic financial markets and corresponding regulatory framework configurations have been subject to transformative changes that ultimately seek to balance and reconcile corporate performance with effective regulatory oversight mechanisms. In this context it is noteworthy that incessant changes in the 'nature of firms and markets' as *Denis* (2001)[5] highlighted are likely to 'challenge the more fundamental bases on which our current ideas about corporate governance are built.'[6] This underlines the importance of empirical, structured research centred on the trajectory of corporate governance evolution in a UK legal context. Despite these key generational developments being reflected in the quantity and variety of corporate governance research literature, produced over the last two decades, we observe further significant methodological shortcomings. Indicative of this is the widespread use of cross-sectional databases[7] instead of longitudinal databases and/or a combination thereof when analysing historical and current corporate governance development parameters and contextualising these within financial markets and financial market growth. Therefore we establish that the academic analysis produced thus far, lacks a systematic, coherent, critical in-depth approach, based on longitudinal empirical data that refines the conception of corporate governance evolution in a UK legal context. Consequently, for the past two decades it has generally offered more questions than answers to academics and practitioners alike.

An analysis presenting and addressing some of the most pressing research questions, albeit based on more narrow economic perspectives, has been offered by *Kole* and *Lehn* (1997), highlighting that "little is known about the evolution of governance structures"[8]. The authors identify the lack of systematic analysis, including corporate governance structure stability patterns and their parameters.[9] Significantly, they pose questions surrounding their potential to adapt[10] to dynamically changing corporate environments including the respective *costs* of these potential changes. While *Kole* and *Lehn* introduce the concept of corporate governance evolution and present an interesting line of argumentation, stating that 'firms that fail to adapt their governance structure to changes [...] face extinction, leading to a natural selection of efficient organizational forms'[11], which has also been referred to as the 'Darwinian view' on corporate governance organisation, significantly they also acknowledge the

[4] Stacey Kole, Kenneth Lehn, 'Deregulation, the Evolution of Corporate Governance Structure, and Survival' [1997] The American Economic Review 421
[5] Diane K. Denis, 'Twenty-five years of corporate governance research … and counting' [2001] Review of Financial Economics 191
[6] Ibid
[7] Ibid
[8] Stacey Kole, Kenneth Lehn, 'Deregulation, the Evolution of Corporate Governance Structure, and Survival' [1997] The American Economic Review 421
[9] Ibid
[10] Ibid
[11] Ibid

'absence of evidence'.[12] Similarly and more importantly they also note an absence of a 'general deeper understanding' pertaining to the adaptation of the Darwinian view, thereby illustrating its very limitations. While it can be recognised that corporations are increasingly entering an international competition[13] and as such, are competitors for the best organisational structure, the 'Darwinian view' of corporate governance evolution appears too simplistic, excluding various additional factors that contribute to corporate governance evolution, such as geopolitical and/or socio-political[14], technological and other external circumstances. Most significantly however, *Kole* and *Lehn* offer only a monistic economic perspective concentrating on a single industry: the airline industry, which undoubtedly is potent in character but certainly not representative of an entire economy. This produces a somewhat in-depth - yet compartmental and thus incomplete perspective. Therefore our empirical evidence based on longitudinal analysis intends to fill this gap by offering a multidimensional approach to UK corporate governance evolution in the context of the OECD regulatory principles.

A more analytical robust and historically detailed analysis is offered by *Coffee* (1999)[15] and later by *Cheffins* (2001)[16]. Despite *Coffee's* research being largely US centred, he frequently references and historically contextualises developments in UK corporate governance, which produces insightful comparative perspectives. Significantly, in consideration of the scope and extent of this research paper, *Coffee* addresses highly relevant normative questions pertaining to corporate governance evolution in his work, such as divergence and convergence trends. These trends must be considered as important present and future characteristics of UK corporate governance evolution. Interestingly *Coffee* concludes that the law only plays a minor[17] role: 'investors depend on relationships, not law'[18] which notably our research supports with empirical evidence. Moreover both, *Coffee* (1999) and *Cheffins* (2001), highlight the UK's unique[19] corporate governance position in western financial markets by reference to the design and evolution of its regulatory framework. Pioneering efforts by both authors, offer a more substantial comparative finance-historical context to corporate governance evolution and fill some important gaps in the literature by setting their research findings into a useful, larger multidisciplinary framework. However both authors contribute largely *descriptive* pieces of work that not only lack empirical evidence but more significantly fail to thematise and subsequently scrutinise

[12] Stacey Kole, Kenneth Lehn, 'Deregulation, the Evolution of Corporate Governance Structure, and Survival' [1997] The American Economic Review 421
[13] J Gordon and M Roe, *Convergence and Persistence in Corporate Governance* (Jeffrey N. Gordon and Mark J. Roe eds, CUP 2010)
[14] Marianna Belloc and Ugo Pagano, 'Co-evolution of politics and corporate governance' [2008] International Review of Law and Economics 106
[15] John C. Jr. Coffee, 'The future as history: the Prospects for Global Convergence in Corporate Governance and its Implications' [1999] Northwestern University Law Review 641
[16] Brian R. Cheffins, 'History and the Global Corporate Governance Revolution: The UK Perspective' [2001] Business History 87
[17] John C. Jr. Coffee, 'The future as history: the Prospects for Global Convergence in Corporate Governance and its Implications' [1999] Northwestern University Law Review 641
[18] Ibid
[19] Brian R. Cheffins, 'History and the Global Corporate Governance Revolution: The UK Perspective' [2001] Business History 87

the most important period of UK corporate governance evolution: the last two decades, which define significant corporate governance reforms. Given the exponential rise in corporate governance regulatory frameworks during these two decades both research approaches are insightful but remain incomplete and therefore unsatisfactory.

Keasey, Thompson and *Wright* (2005) delivered one of the first comprehensive, descriptive monologues on the development of UK corporate governance. In that sense this paper presents a methodological as well as an interpretative advancement of their theories in aspects. Amongst other things the authors introduce and discuss relevant significant corporate governance parameters, such as the role of financial market structures, the role of the *normative* 'nature of the corporate form'[20] and the influence of regulatory institutional frameworks. In this respect the work by *Keasey, Thompson* and *Wright* has laid the groundwork for corporate governance development analysis. Certainly its greatest strength is illustrated in their continuous, critical approach, which pertains to elaborate on challenges, and particular problematic issues surrounding this research area. This means that the authors address, critically contextualise, and juxtapose several aspects of proponent and opponent viewpoints relating to corporate governance systems and structures. However the work of *Keasey, Thompson* and *Wright* does appear incomplete. It falls short in presenting at least one detailed, longitudinal empirical analysis of the relevant corporate governance parameters mentioned above. Our research paper intends to fill this gap by providing the first longitudinal, empirical analysis that covers the most significant, recent corporate governance development period from 1995-2014, critically analysing *and* contrasting individual UK norms against the respective regulatory OECD principles to provide empirical evidence relating to the role, evolution and configuration of 'law' in the context of UK corporate governance performance.

De Nicolo, Laeven and *Ueda* (2007) published an interesting empirical, longitudinal (1994-2003) study that analyses cross-country *quality* of corporate governance, specifically examining 'reforms, new laws and regulations' in the context of a corporation's financial performance. Their study heavily scrutinises and contextualises empirical data constructing a *corporate governance quality* (CGQ) index. The evolution of this quality index is observed between the years 1995-2014 and the 'impact of measured improvements on output growth, productivity growth' and investment on country level and on industry growth is assessed. Controversially their analysis on corporate governance quality evolution suffers from three substantial deficits, which our research attempts to rectify. Firstly their set parameters on defining 'corporate

[20] Kevin Keasey, Steve Thompson and Mark Wright (eds), *Corporate Governance – Accountability, Enterprise and International Comparisons* (John Wiley & Sons 2005)

governance quality – in trends and real effects' are highly subjective. The authors did not define nor explain their definition and/or categorisation parameters in the context of 'quality'. Given that the term quality can itself be viewed as highly subjective, the author's research outcome logically implies a great(er) subjectivity and can therefore not be viewed as suitable for drawing more generalised conclusions. This undermines the paper's significance and consequently lessens its analytical effectiveness. Secondly *De Nicolo, Laeven* and *Ueda* explain that they are using 'outcome based measures' of corporate governance, as opposed to '*de jure*' measures'.[21] Despite the authors illustrating several advantageous aspects of the 'outcome based measures' approach, it nonetheless appears to be deficient. That means the authors argue that analysing '*de jure*' measures of corporate governance is 'difficult'. While this in principle is true, establishing '*de jure*' subcategories that incorporate and structure the variety of legal corporate governance regimes would complement the 'outcome based analysis', without sacrificing important legal analytical elements. In other words, their contribution would have been enhanced by a combination of the two. Additionally *De Nicolo, Laeven* and *Ueda* offered a relatively short time frame analysis of only nine years, more significantly excluding the years centring on the financial crisis. It is this particular gap that our research fills, by offering a crucially longer empirical analysis including not only the important 2007-2009 time period but also offering a *combined* analysis of economic and legal factors pertaining to UK corporate governance evolution.

In 2009 *Arcot, Bruno* and *Faure-Grimaud* presented an empirical micro-regulatory analysis[22] that focuses on the role of the law pertaining to the functionality of the 'comply or explain' approach, enshrined in the 'UK Corporate Governance Code'. Their contribution firstly dissects the characteristics of 'the Code' by contrasting its regulatory flexibility with more mandatory, statutory corporate governance regimes and secondly contextualises and discusses these finding in terms of whether this voluntary compliance 'comply or explain' is working, i.e. analysing their *effectiveness* in terms of monitoring and enforcement. While the authors discuss fundamental aspects of UK corporate governance in relation to soft law versus hard law approaches, their work appears somewhat simplistic and overly generalising. Consequently their line of argumentation suffers from a mono-perspectival analysis. Given that corporate governance analysis in any context is a highly complex process, the author's approach remains unpersuasive. Symptomatically, the authors assert that 'a more statutory regime [to corporate governance] would lead to a "box-ticking"

[21] Gianni De Nicolo, Luc Laeven, Kenichi Ueda, 'Corporate governance quality: Trends and real effects' [2008] Journal of Financial Intermediation 198

[22] Sridhar Arcot, Valentina Bruno, Antoine Faure-Grimaud, 'Corporate Governance in the UK: Is the comply or explain approach working?' [2009] International Review of Law and Economics 193

approach'.[23] This statement fails to recognise the objective, almost technical precision of more statutory legal regimes, which by no means must result in a mere box-ticking approach. Therefore the authors clearly refer to characteristics of the *implementation* of this approach and not to its inherent, underlying (useful) structural elements. That means not only do the authors fail to present quantifiable data and/or hermeneutical evidence to support their assertion, conversely they also generalise specific characteristics of 'more statutory regimes', which in actual fact represent the majority of global legal systems, in order to support their theory. Thus their analysis, despite offering some useful insight remains undifferentiated, limited to largely broad-brush comparisons.

Several years later *Matos* and *Faustino* (2012) [24] introduced an insightful complementary piece of empirical research that applies econometric estimation techniques to the analysis of European corporate governance evolution, specifically in the context of convergence.[25] Although the analysis is very short it poses a number of interesting and important questions, such as does the level of corporate governance convergence across European countries correlate to a specific legal/institutional framework? Thereby the authors significantly link and explore empirical corporate governance analysis to particular "cultural and political facets relevant to the convergence process". It is this conceptual interdisciplinarity that furthers the academic discussion in this field substantially, as the authors demonstrate that the convergence process differs between the Anglo-American and Continental models of corporate governance. Significantly this means that authors produce evidence that the regulatory framework, and more specifically the law, matter. Our paper goes further by exploring exactly *how* we think it matters. However the authors themselves identify a number of shortcomings in their work, namely the lack of additional control variables allowing for a more dynamic analysis. This gap is filled by our empirical analysis.

Finally *Zalewska* (2014)[26] presents a qualitative post Cadbury and Sarbanes-Oxley corporate governance analysis[27] pertaining to specific challenges in the context of regulatory advancements, significantly claiming that 'governments, regulators and shareholders have, since the 1990s, transformed the natural *evolution* of corporate

[23] Sridhar Arcot, Valentina Bruno, Antoine Faure-Grimaud, 'Corporate Governance in the UK: Is the comply or explain approach working?' [2009] International Review of Law and Economics 193
[24] Pedro Verga Matos, Faustino C Horacio, 'Beta-convergence and sigma convergence in Corporate Governance in Europe' [2012] Economic Modelling 2198
[25] Anna Zalewska, 'Challenges of corporate governance: Twenty years after Cadbury, ten years after Sarbanes-Oxley' [2014] Journal of Empirical Finance 1
[26] Ibid
[27] Ibid

governance into a *revolution*'.[28] The author discusses the question as to what caused the dramatic regulatory changes in that period highlighting the individual regulatory steps taken by the different legislators (UK and US). Despite offering an interesting comparative legal analysis between UK and US corporate governance regulatory reforms, the contribution lacks greater in-depth critical analysis that explores the correlation between financial markets and the law; it also fails to empirically link and contextualise these finding. Therefore *Zaleweska*'s work appears incomplete and remains somewhat superficial in its research approach.

To conclude, previously produced literature and research findings on empirical UK corporate governance evolution, considering longitudinal data sets that cover a sufficiently long and crucial time period (e.g. the financial crisis) appear insufficient and significantly under researched. As demonstrated above current literature lacks in-depth critical analysis that contextualises the role of the law *in conjunction* to a company's performance on the UK financial market. It has been asserted that the "law clearly matters"[29] but at the same "just how is less than clear".[30] We present evidence to demonstrate that law does in fact play a role, but that role is a different, more differentiated one.

Methodology

The 2004 OECD Principles of Corporate Governance constituted the major piece of international regulation, which gained widespread attention in the early part of this century. Most developing countries fashioned their corporate governance regulations based on these principles. Thus from a comparative law perspective the OECD principles provide a touchstone to measure to what extent a country has adopted the generally recognised uniform corporate governance principles. Another dimension worthy of exploration is the tilt towards shareholder primacy corporate governance, although a lip service is paid to stakeholderism as OECD principles mostly tend to lean towards shareholder primacy corporate governance. Thus an empirical analysis which studies the evolution of UK corporate governance pegged to the 2004 OECD standard would also reveal the increased or decreased tilt to shareholder primacy corporate governance.

We analyse fifty-two variables each of which is capable of three basic answers: absent, optional or not widely enforced, and compulsory or widely enforced. Thus the study tries to bridge the gap between law in books and law in action. We also move beyond

[28] Anna Zalewska, 'Challenges of corporate governance: Twenty years after Cadbury, ten years after Sarbanes-Oxley' [2014] Journal of Empirical Finance 1

[29] R Morck and L Steier, *The global history of Corporate Governance: an Introduction* (Randall K. Morck ed, University of Chicago Press 2005)

[30] Ibid

the binomial paradigm of presence or absence of law in books, which still finds favour in much empirical work. A brief variable description is given in Appendix A, it is thematically divided into four subcategories Anti-Stakeholder rights index, Minority shareholders rights index, Anti-Managerial rights index and Shareholder rights index. The completed questionnaire for the UK for 1995-2014 is available in Appendix B. The coded table is available in Appendix C.

An item response model with Kalman filter is used to compress the data into an index. Computer codes for the same are available in Appendix D. For a quasi-experimental analysis of the impact we also look at five financial market variables namely - S&P global equity index, traded volume of stocks traded, Number of listed domestic companies, Market capitalisation of listed companies, and Foreign Direct Investment (FDI). An explanation of the variables is available in Appendix E. These five variables are melded into a financial market development index by executing a Bayesian factor analysis. The computer code is available in Appendix D.

In undertaking the quasi-experimental analysis exploratory techniques like change point analysis are first used. This will show the time period when change(s) has/have occurred in the overall normative corporate governance evolution in addition to financial development. This will help to pinpoint whether corporate governance ‘improvements’ follow financial boom or if it is the other way round. We use the R package bcp to implement the change point solutions.[31]

Historical Context

It is notable that the UK is predominantly a Common Law jurisdiction (although it should be recognised that Scottish Law is a hybrid Civil/Common Law system rooted in Roman law). Principally the impact of the common law is felt in two effects, firstly, legislation may anticipate, and give authority to further detail, provided as secondary legislation, or regulation, and that the courts have an interpretative role where legislation is brought before them; and secondly, that law – the Common Law - is developed through the courts quite separately to the provisions of Parliament. Legislation is by its nature less detailed and all encompassing than might be the case in Civil law jurisdictions, allowing Parliament to revisit as necessary, without disruption of any wider design. The English courts interpret and apply legislation, but also adjudicate on issues outside of statute in common law developing law through binding precedent or *Stare Decisis*. This background is useful in providing the context of the development of corporate governance in the UK.

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[31] bcp: Bayesian Analysis of Change Point Problems <https://cran.r-project.org/web/packages/bcp/index.html>

The core of the 20th century approach to the establishment and governance of companies is founded in the legislative provision of the first half of the 19th century. The legislation from 1844 onwards established the pattern for the incorporation of companies in the UK, and thereby the theoretical presumptions, which have formed the basis of the UK approach to corporate governance throughout the major part of the 20th century. Until the period of legislation beginning with the Joint Stock Companies Act 1844 the exception to the 'unincorporated joint stock company' were those relatively limited examples of companies created by Royal Charter or Private Act of Parliament. The former not insignificant in giving rise to esteemed organisations and pillars of society, and the latter facilitating significant sectoral industrial progress, e.g. through the railways.

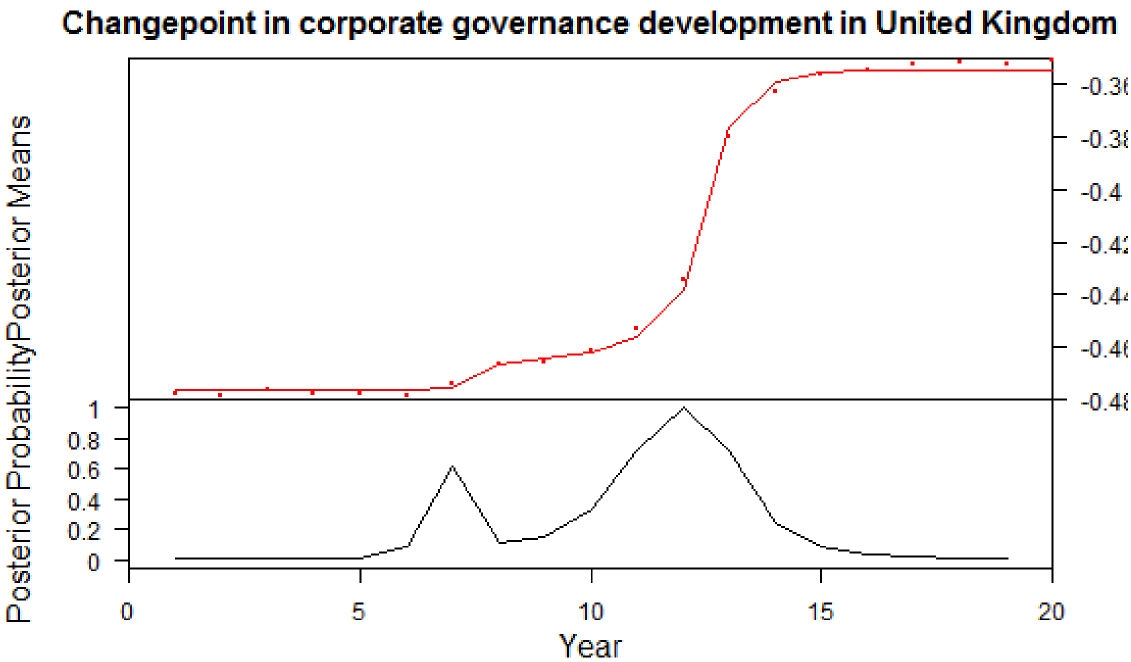
Potential for growth in the dominant model of the 'unincorporated joint stock company' however became, limited and failing to meet the appetite for economic growth. Moreover, the demands of industry and commerce were two-fold: incorporation and limited liability. Whilst the former was provided by the Joint Stock Companies Act 1844 (the Gladstone Act) the latter was rather more controversial. The call for limited liability to be enshrined in statute rested upon a number of differing arguments. Principally, it was argued that 'limited liability' was needed to provide security for small investors who would otherwise remain outside of industrial development, and thereby restrict the potential pool of investors essential for continued economic growth. At this time a distinction was also drawn between those investors who had been able, by the terms of their contractual relationship with the subject company, to exclude potential liability, and those who had not been able to secure such an advantageous position. As a contract is an obligation created and policed by the parties themselves, it would be beyond the control of Parliament, and the differential position of those with contractual protection and those without could therefore only be addressed by legislation imposing a broader limitation of liability as represented by the Limited Liability Act 1855; the combined position better facilitating the corporate economy (Hannah, 1983)[32]. Although the legislative framework has been added to from time to time, the shape of company formation and governance was largely established until the late 20th century with the emergence of the current focus on corporate governance.

The *laissez-faire* principles dominant in the 19th century remained influential in the 20th century, not least in relation to the general hands-off, non-interference stance directed towards the growing corporate economy (Hunt, 1936)[33]. The immanent principles relating to property rights became extended to corporate property,

[32] Leslie Hannah, *The Rise of the Corporate Economy* (2nd edn, Methuen 1983)
[33] Bishop C. Hunt, *The Development of the Business Corporation in England 1800 – 1867* (Harvard University Press 1936)

notwithstanding their incorporation, influencing the emergence of the doctrine of shareholder value. However, beyond this there is little evidence of further overt development in terms of corporate governance during this period, suggestive not least of a lack of interest on the part of successive governments. The reasons are no doubt complex, but may be summarised on the part of Conservative governments on the basis that the status quo presented no real issues at the time. In contrast, it might seem surprising that the post-war Labour governments were similarly silent, the answer here may simply be that their interests lay elsewhere, principally in relation to the focus on public ownership and the development of the Welfare State. During the period of the Blair/New Labour government starting in 1997, the outlook of the Labour party had changed, and domestic and global corporate events meant that the subject of corporate governance could no longer be ignored. However, that is not to say that the Labour governance had shown no interest, as indicated by the report of the Committee of Enquiry into Industrial Democracy (1977), otherwise known as the Bullock Report. The report, which was in response to the European Commission's draft 5th Company Law Directive sought to harmonise worker participation in management proposing a form of worker involvement within company governance. Whilst this might have been viewed as representative of a move towards a broader stakeholder perspective, we should not overlook the fact that the recommendation also presented a potential means of addressing the inherent problems of a period of enduring industrial dispute.

Empirical analysis of corporate governance evolution in UK



The change in corporate governance in the UK in the last twenty years is minimal, but the probability of any change point in the last twenty years is highest in year 12 (probability: 1) with minor changes in year 7 (probability: 0.62), year 11 (probability: 0.72) and year 13 (probability: 0.72). The major shift corresponds to the year 2006 with minor shifts in 2001, 2005 and 2007. These shifts can be attributed to the publication of several non-binding codes such as good practice suggestions from the Higgs Report[34] and the publication of the Combined Code on Corporate Governance by the Financial Reporting Council (FRC) in 2006; the Myners Report[35] and the Code of Good Practice[36] by Association of Unit Trusts and Investment Funds in 2001; and on Internal Control: the Revised Guidance for Directors on the Combined Code published by FRC in 2005 etc. The above highpoints will now be discussed in greater qualitative detail.

The Combined Code 1998

The Combined Code 1998, prompted by the collapse of Barings Bank etc, incorporated the key elements of the Cadbury[37], Greenbury[38], and Hampel[39] reports, disseminating what should be 'best practice' in corporate governance (Parkinson and Kelly, 1999)[40]. The compliance strategy adopted relied on voluntary disclosure, through the mechanism of 'comply or explain'. The self-regulatory approach might be viewed quizzically by some, but the requirement to 'explain' supports transparency, and presented something of a challenge to companies with effective self-regulation reducing the need for future statutory control (Gamble and Kelly, 2001)[41].

The Combined Code represents a reactive stance. The influential Cadbury Report itself was a private initiative established by the Financial Reporting Council, the London Stock Exchange and the accountancy professions, in response to a series of high profile corporate events. Indeed, the nature of the initiative allowed the enquiry to broaden its remit in the light of further incidents (particularly BCCI and Maxwell). The broad aim of the Committee was to raise standards of financial reporting and accountability in UK listed companies, although its impact was in fact more widespread, influencing the development of corporate governance codes more widely.
Whilst primarily focused on the need to enhance standards of financial reporting and accountability, the approach taken by Cadbury envisaged that the board would

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34 Financial Reporting Council (FRC), 'Good practice suggestions from the Higgs Report' (2006)
35 HM Treasury (2001) '*Institutional Investment in the UK: A Review*' Paul Myners
36 Association of Unit Trusts and Investment Funds, 'Code of good practice' (2001) <http://www.ecgi.org/codes/documents/autif.pdf>
37 Sir Adrian Cadbury, *Report of the Committee on the Financial Aspect of Corporate Governance* (Gee & Co. Ltd. 1992)
38 Sir Richard Greenbury, *Directors Remuneration* (Gee & Co. Ltd. 1995)
39 Sir Ronnie Hampel, *Committee on Corporate Governance: Final Report* (Gee & Co. Ltd. 1998)
40 John Parkinson, Gavin Kelly, 'The Combined Code on Corporate Governance' [1999] Political Quarterly 101
41 Andrew Gamble, Gavin Kelly, (2001) 'Shareholder Value and the Stakeholder Debate in the UK' [2001] Corporate Governance 110

nonetheless be enabled to push the company on to take advantage of a competitive environment, albeit with the expectation of accountability, even though of a voluntary nature. It was not intended to lead to corporate sterility, but rather ensure a higher level of Best Practice highlighting transparency within a voluntary regulatory framework, where compliance may not always be demanded, but must always be explained.

Recommendations of the Report on the Financial Aspects of Corporate Governance (Cadbury), focused on the reporting function, and relationship between board, audit, and shareholders. The Code of Best Practice being based upon the key precepts of openness, accountability, and integrity. The comprehensive framework represented in Cadbury sought, inter alia, to define a template for clear and transparent governance, from the need for regular board meetings retaining effective control and oversight of the executive management, to recognition of the value of nonexecutive directors both in bringing an independent perspective in relation to strategy and performance, and providing a measure of independence on questions of remuneration, to attention to the relationship with auditors with reference to both audit and non-audit services etc.

The later Greenbury Committee, an initiative of the CBI, reporting in 1995 in response to public and shareholder concern over director remuneration, followed Cadbury quite swiftly. Whilst the focus of Greenbury was much narrower than Cadbury, they shared a commonality of theme, particularly in relation to accountability, responsibility, transparency and full disclosure, the alignment of director and shareholder interests, and improved company performance, in addition to the headline concern relating to directors' remuneration.

The final limb of the triumvirate leading to the Combined Code is represented by the Hampel Report. The Hampel Report on Corporate Governance (1998) came from an initiative of the Financial Reporting Council. Its remit whilst broader than Cadbury and Greenbury, built upon the earlier reports, generally endorsing the findings of each of them. Hampel, however, does go further than its predecessors in emphasising the significance of the institutional investors themselves, in relation to the governance of the investee companies. The overall theme of transparency communicated by the earlier reports, however, remains evident.

Drawing from the 3 reports the Combined Code 1998 addresses two broad themes: the first relating to the governance of companies, calling on the board to 'maintain a sound system of internal control to safeguard share-holders' investment'; the second focusing on the institutional investor. Relying upon the detailed considerations of Cadbury, Greenbury, and Hampel, the Combined Code represents a timely and effective response to the emerging millennial corporate landscape. The compliance strategy of 'comply or explain' established the pattern of the UK regulatory approach.

The Revised Combined Codes

The basic template for corporate governance in the UK provided by the original Combined Code has been revisited on several occasions (2003, 2005 and 2006). The first in 2003 responding to, and incorporating the key recommendations of both the Higgs, and the Smith reports, with later updating taking place in 2005 and 2006 before the major revision in 2010 (see below).

Higgs[42], reporting in 2003, was tasked with a review of the effectiveness of the existing provision in relation to non-executive directors, and the audit committee. As had been the case on previous occasions, the review of the provision in UK law was timely in the light of the reverberations of yet another corporate scandal, in this instance Enron. The failings of Enron related not only to their own activities, but extended to their auditors who had failed to press directors hard enough in relation to concealed losses. The comparison with the UK response in the Higgs review, and that of the USA is striking. Whereas the former continued in supporting the existing UK non-prescriptive, 'comply or explain' approach, the latter introduced the Accounting Industry Reform Act 2002 (Sarbanes-Oxley Act), protecting investors from fraudulent accounting by corporations by imposing mandatory requirements on CEO's and CFO's supported by serious criminal sanctions. Higgs did recommend more stringent requirements in relation to both the membership of boards and the appraisement of independent directors, but nonetheless remains loyal to the non-prescriptive approach. The impact of the Sarbanes-Oxley Act cannot, however, be ignored as the sphere of application is not strictly limited to US companies, but extends to both US and non-US companies, even where the Act may be in direct conflict with the home nation's domestic regime of corporate governance. The effect has been for some companies to choose to become delisted from the NYSE, and for others to be dissuaded from applying.

The Smith Review (2003) also reflected the significance of the company audit committee, and the necessary independence of auditors. In relation to the former, Smith impressing the significance of the role to 'ensure that the interests of the shareholders are properly protected in relation to financial reporting and internal control' (para 1.5), further underpinning the shareholder value approach in UK corporate governance.

The UK Corporate Governance Code

[42] Derek Higgs, *Review of the Role and Effectiveness of Non-executive Directors* (DTI 2003)

In 2010 the Combined Code was revised, in the light of the Davies and Sharman Reports, and re-designated as the UK Corporate Governance Code (with further updates following in 2012 and 2014). The updated code does not represent any distinct change of direction, but does introduce a new focus on 'diversity disclose' in relation to director mix, and stresses the need to set the right 'tone from the top'. Beyond this development, the significance of the revisions relate largely to the continuing themes of: risk management and internal control; remuneration (stressing the need to link to delivery of long-term benefits to the business); and shareholder engagement.

Whilst the 2010 code, as updated, does not present any radical change of direction, the significance of a regularly updated and informed code is representative of a mature controlled approach to corporate governance, albeit one that remains largely reactive in nature.

The Companies Act 2006

Since its emergence in the Cadbury Report, corporate governance in the UK has largely relied upon a narrow outlook, focusing on profit maximisation through the prioritisation of the shareholder. We have, however, already noted that this is not the only approach that might be adopted, nonetheless although Hampel (para 1.3) suggests that good governance will ensure that stakeholders with an interest in the company will be taken into account, it is difficult to see this as reliable in such a shareholder centric framework. Broader definitions have been mooted (Sheridan and Kendall, 1992)[43], and are more characteristic of some other jurisdictions, and particularly relevant to some other EU jurisdictions, and the process of EU harmonisation. The 1999 Consultation Document (Modern Company Law for a Competitive Economy: The Strategic Framework), reflected upon broader interests which may be served, drawing a distinction between the 'enlightened shareholder value' approach which would suggest that such interests could be benefited within the present framework, and a 'pluralist' approach which would facilitate the wider stakeholder interest, but would demand significant changes to company law with, particular impact on directors.

Much of the development of corporate governance in the UK to this point has rested upon the notion that the governance of the company is presumed to be solely in the interest of the shareholder. We may note the terms of s 309 of Companies Act 1985, which provides that directors should have regard to the 'interests of the company's employees', but it is suggested that this did not make significant inroads on the shareholder/stakeholder debate, not least for the reasons identified below.

The Companies Act 2006 represented a timely and necessary review of the law, taking the opportunity to reflect upon the pre-existing position focusing on the shareholder, but encouraged by the Company Law Review, to adopt a more 'enlightened shareholder' approach. This is particularly reflected in s 172 which establishes a

[43] T Sheridan and N Kendall, *Corporate Governance, An Action Plan for Profitability and Business Success,* (Financial Ties/Pitman Publishing 1992)

broader duty on directors, acting in good faith, to ‘promote the success of the company for the benefit of its members as a whole’, having regard to a (non-exhaustive list) of considerations including: reference to the long-term consequence of their decisions; the interests of employees; relationships with other stakeholders (suppliers, customers etc.); the wider community and environment; maintaining the reputation and standards of the company; and the obligation to ‘act fairly as between members of the company’.

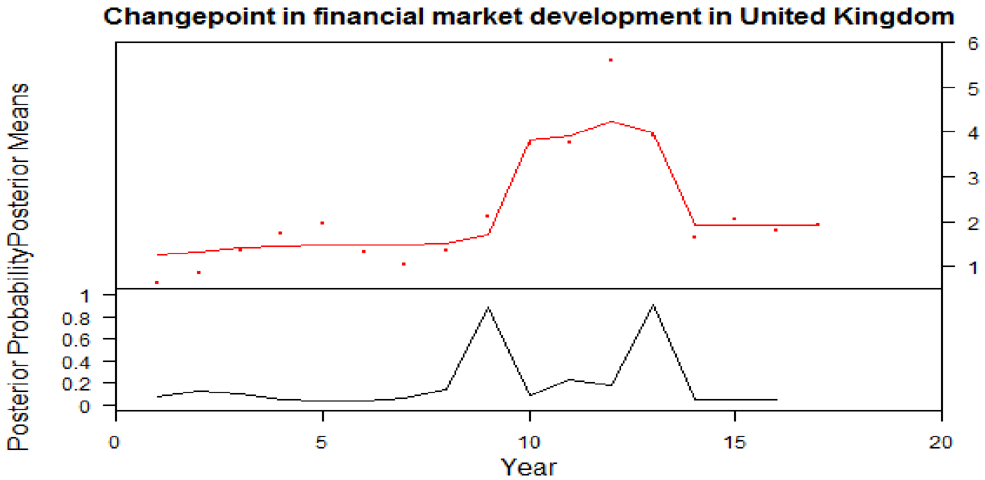
Taken at face value, s 172 would seem to support a change of direction in corporate governance in the UK, broadening corporate responsibility from a narrow shareholder perspective, to a wider community of stakeholders. However, it continues to be the case that shareholders remain the principal focus, with the secondary stakeholder interests only being relevant to the extent that the directors, acting in good faith, consider it necessary/appropriate to have regard to them, when acting ‘for the benefit of its members as a whole’. Further, it should be noted, that any opportunity to challenge the exercise of the directors’ discretion under s172 is, arguably, limited to the point of sterility. The decision to litigate lies with the directors, meaning that those allegedly acting contrary to the Act may themselves have sufficient weight to block an action, even where a fully independent board considers it necessary to ‘promote the success of the company’ under s172. Which perhaps questions the extent to which s172 represents any real change in the shareholder value perspective. This is not a new problem, but one, which also restricted the practical significance of s 309 of the 1985 Act (Keay, 2007)[44].

The Stewardship Code 2010

Emanating from the Financial Reporting Council, the Stewardship Code attends to the position of institutional investors with voting rights, extending expectations in relation to transparency to their voting, and voting policy. The practical effect of the code is to enhance the engagement of institutional investors, which in turn will pay dividends in relation to the corporate governance of the investee company, and encourage openness and transparency in relation to their own compliance in the investor’s home company. The approach encourages transparency in relation to the stewardship function, giving a two-way benefit, maintaining continuity with the ‘comply or explain’ model.

Development in Financial Market Growth

[44] Andrew Keay, ‘Tackling the Issue of Corporate Objective: An Analysis of the United Kingdom’s Enlightened Shareholder Value Approach’ [2007] Sydney Law Review 577



The probability of change points in UK financial market development is highest for year 9 (probability: 0.88) and year 13 (probability: 0.91), corresponding to the years 2004 and 2008 respectively. There was a sustained upswing in the financial market in the UK from 2003 to 2007, which Ben Bernanke 'argued that, probably thanks to better theory of monetary policy, the world had entered the era of "great moderation", in which the volatility of prices and outputs is minimised.'[45] The FTSE regained the height of the late 1990s dotcom boom.[46] Mervyn King, the then Governor of the Bank of England termed the years as the 'nice' (non-inflationary consistently expansionary) decade,[47] which Gordon Brown, the then Chancellor of the Exchequer, claimed helped solve the 'boom and bust' economics leading to ever greater economic growth.[48] It is postulated here that deregulation and the 'benign macro-economic situation encouraged investment in both capital and financial investments. [...] Financial institutions became willing to take on more risky investments because they were more confident that there would not be any major economic downturn.'[49] This nonetheless led to the Global Financial Crisis of 2008 and

[45] Ha-Joon Chang, 'This is no recovery, this is a bubble – and it will burst' *The Guardian'* (London, 24 February 2014) <http://www.theguardian.com/commentisfree/2014/feb/24/recovery-bubble-crash-uk-us-investors>

[46] BBC, 'Investors celebrate stock market boom' (31 December 2003) <http://news.bbc.co.uk/1/hi/business/3359241.stm>

[47] Speech given by Mervyn King, Leicester 14 October 2003 as cited in Treasury Committee, House of Commons, *Banking Crisis: Dealing with the Failure of the UK Banks : Report, Together with Formal Minutes* (Seventh report of session 2008-09) 12

[48] Deborah Summers, 'No return to boom and bust: what Brown said when he was chancellor' (*The Guardian*, 11 September 2008) < http://www.theguardian.com/politics/2008/sep/11/gordonbrown.economy > accessed 15 May 2015

[49] Tejvan Pettinger, 'The Great Moderation' (*Economics Help*, 21 February 2013) <http://www.economicshelp.org/blog/6901/economics/the-great-moderation/> accessed 15 May 2015

the London Stock Exchange suffered the worst fall in its history.[50] As shown in the graph above, the post-2008 the financial market fell back to its pre-2004 level. Therefore we find little correlation between the changes in corporate governance and the financial market. In our analysis we find that financial market growth in the UK is governed to a greater extent by the macro-economic climate rather than changes in (Common) law. There might be two main reasons for this. Firstly the 'comply or explain' regime in UK along with an impactful rule of law makes corporate governance easy to implement - but makes it more difficult to facilitate for any perceptible change in the culture of the financial market. Consequently we argue against the 'law matters' hypothesis. Secondly, the UK being a global hub of financial market reacts more to vagaries of global financial movements rather than changes or reforms in the light touch of respective domestic regulations.

Corporate Governance Reform

In 1999 the OECD issued their 'Principles of Corporate Governance' (revised 2004), after wide consultation with national governments, the private sector, International Banks etc. The OECD Principles represent common characteristics recognised as necessary for good corporate governance and share commonality with our own internal framework over a range of areas. However, the key point of divergence relates to Principle IV, which focuses specifically on the role of stakeholders in corporate governance. The OECD highlight their preference for corporate governance models to recognise the rights of stakeholders, and 'encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises'. To a certain extent it might be suggested that s309 Companies Act 1985, and s172 Companies Act 2006 represent significant movement in the direction of stakeholder values, however, as indicated above, the categories of stakeholder indicated in both Acts of Parliament remain secondary considerations for the board, who are only required to consider them to the extent that they 'consider(s), in good faith… most likely to promote the success of the company for the benefit of its members as a whole…'. In addition, the limited opportunity to challenge directors in relation to s309 (1985) and s172 (2006), may lead us to consider that although stakeholder interests may be advertised in the corporate 'window', they are not for sale in the corporate 'shop'.

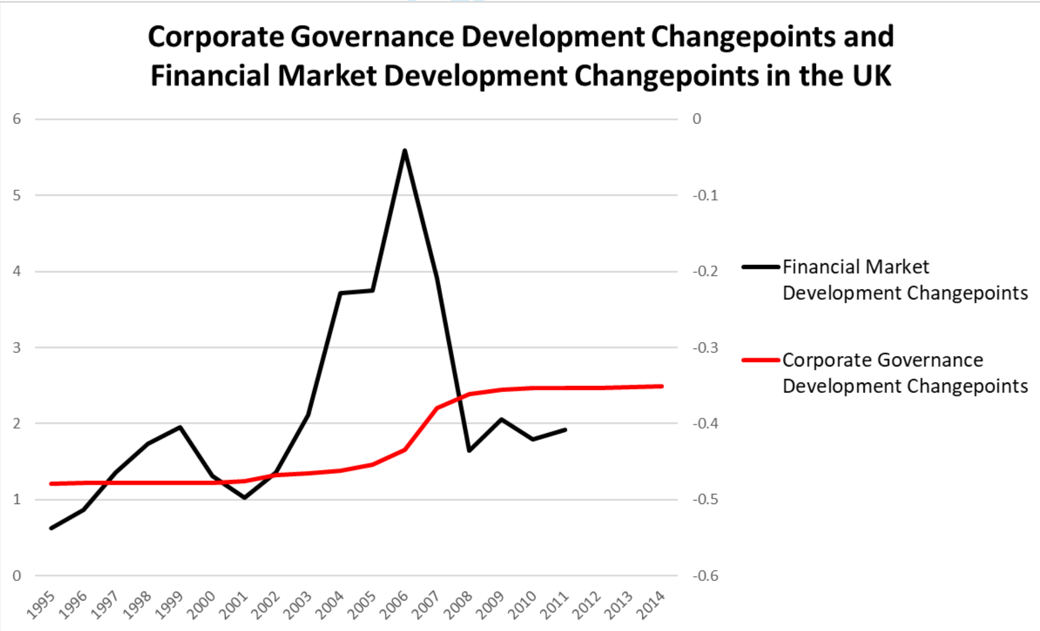
It follows that the current position would therefore suggest that any move towards convergence with the OECD principles, or harmonisation in EU terms has, until now been limited. Interestingly, however, in the aftermath of the Brexit vote on 23rd June

[50] Robert Winnett, 'Financial crisis: London stock exchange suffers worst fall in history' *The Telegraph* (London, 6 October 2008) <http://www.telegraph.co.uk/finance/financialcrisis/3147764/Financial-crisis-London-stock-exchange-suffers-worst-fall-in-history.html>

2016, we have seen a greater interest in the incorporation of stakeholder values into the UK corporate governance framework. In particular, the Green Paper on Corporate Governance Reform, published in November 2016 states the purpose of corporate governance being to 'facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of a company' adding that 'A key element is protecting the interests of shareholders where they are distant from the directors running a company. It also involves having regard to the interests of employees, customers, suppliers and others with direct interest in the performance of a company'.

Contextualising Corporate Governance and Financial Market Development Change Points

In order to visualise the evolution of normative corporate governance change points against the time specific financial market development change points based on our empirical data the two graphs have been merged as illustrated in the following diagram.



The diagram illustrates the combined previously discussed change points. Significantly, it highlights that based on our empirical data we find that financial market development and financial market growth appear to bear little correlation to significant change points in normative corporate governance development. This provides empirical evidence for our argument against the 'law matters' hypothesis and further distinguishes this view, supporting our hypothesis and positing that several historical and economic reasons in conjunction with a robust rule of law in the UK contributed to the development of a strong financial UK market, and the law especially the type or tilt is less relevant.

Conclusion

In mapping the normative development of UK corporate governance between the years 1995 and 2014, we have undertaken the first longitudinal empirical study of its kind advancing and refining the conception of UK corporate governance evolution. The specific change points used for this analysis have been contextualised against the background of UK financial market development and financial market growth. However, we found no statistically relevant empirical evidence pertaining to changes in corporate governance and the financial market, and therefore conclude that there is little correlation between the two. Instead, we argue that changes in UK financial market development and financial market growth up until this point can be explained rather by a combination of other factors. However, notable changes, such as reforms in the UK corporate governance framework, relating to a greater interest in the incorporation of stakeholder values might paint a different picture. Thus, interestingly, in 2017, in terms of its corporate governance legal framework, the UK finds itself in a somewhat paradoxical situation. Whilst it is on the cusp of political *divergence* from its closest trading neighbours (the EU), at the same time it may be closer to the concept of *convergence* of corporate governance ideas now than it has been at any point in the past.