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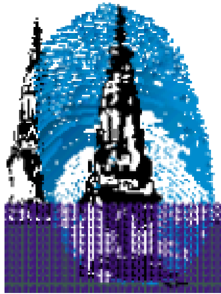

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The Financial Sector and Corporate Governance – Lessons from the UK

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The Financial Sector and Corporate Governance – Lessons from the UK

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Abstract

In 1992 the Cadbury Committee report on the financial aspects of corporate governance was published. The Committee had been established following the failures of a number of high profile businesses in the UK which had shaken confidence in the market. Some nine years later, in 2001, the collapse of Enron sent shockwaves through the US market. As a result of the Enron collapse and various other high profile scandals in the years since its occurrence, the US is examining its own corporate governance structures and provisions to determine how these might be improved and help avoid another Enron. The EU similarly is developing principles and legislation to improve corporate governance, and scandals such as Royal Ahold and Parmalat have helped drive further governance reforms.

In this paper we detail the development of corporate governance codes in the UK and the adaptation of similar codes in the EU. We discuss the role of the financial sector in corporate governance and how principles for regulation and supervision of the financial sector complement codes of conduct and legislation in the area of corporate governance.
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The Financial Sector and Corporate Governance – Lessons from the UK

1. Introduction

The Cadbury Report issued in the UK in 1992 laid the foundations of a set of corporate governance codes, not just in the UK but in countries as diverse as Russia and India, which have incorporated its main principles into their own corporate governance codes. Following on from the collapse of Enron in 2001, and subsequent high profile corporate scandals, corporate governance has gained a much higher profile and it is useful to examine the

development and evolution of corporate governance in the UK to see what lessons might be learnt.

At the outset it is helpful to set the context by briefly reviewing some of the definitions of corporate governance:

Sir Adrian Cadbury (1992) defined corporate governance as 'the whole system of controls, both financial and otherwise, by which a company is directed and controlled'.

The OECD (1999) defined it as 'a set of relationships between a company's board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives, and monitoring performance are determined'.

These definitions illustrate well what corporate governance is and it can be seen that it is concerned with both the internal aspects of the company, such as internal controls and board structure, and external aspects such as the relationship with shareholders and stakeholders. Importantly it also provides the mechanism through which corporate objectives may be set, monitored and achieved.

The academic study of corporate governance goes beyond the above definition and includes mechanism for changes in ownership and management, and the incentives in capital markets for such changes and for managerial conduct. These incentives are based on the need for external funding from banks and public debt and equity markets. The availability of external sources of funding as a key factor for corporate governance was clearly appreciated by Arthur Levitt when he stated 'If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country – regardless of how steadfast a particular company's practices may be – suffer the consequences'.

The above quote does not consider the difficulty of evaluating and comparing different corporate governance systems. These systems are not alike in two countries. Rules and practices in each country have developed over time in a specific legal and political environment. Each system can be thought of as a complex web, wherein the role of certain rules depends on the rest of the system. Thus, when drawing lessons from one country's

experience for another country it is important to consider that there may be many different ways to achieve certain objectives, and that the same rule may have different consequences in different systems. Thus, simply transplanting one element from one country to another may not always lead to the intended consequences. This does not mean that one country cannot learn from another but that mechanisms to achieve certain objectives may have to be designed differently in different corporate governance systems.

The paper proceeds as follows. In the next section we discuss the development of corporate governance in the UK: we consider the environment and framework within which corporate governance has developed; we discuss the main corporate governance provisions in the UK, and we detail the role of institutional investors in UK corporate governance. The role of the financial sector in corporate governance and principles for regulation and information disclosure to achieve effective corporate governance are discussed. We emphasize the role of "market conform" regulation and legislation and the important role of competition in markets as well as among institutional structures. Thereafter we turn to the adaptation of UK corporate governance principles focusing on the US and the EU. Recent US legislation and a report on corporate governance reform in the EU from a "High level Group of Experts on Company Law" will be discussed in light of the principles for market conformity of regulation.

2. Recent Developments in Corporate Governance in the UK

There have been a number of key drivers to increased attention to corporate governance in the UK:

- Firstly, collapses of prominent business, both in the financial and non-financial sectors, such as Polly Peck, BCCI, and later Barings; led to increased emphasis on controls to safeguard assets

- Secondly, the changing pattern of share ownership, particularly in the US and UK, which led to a greater concentration of share ownership in the hands of institutional investors, such as pension funds and insurance companies. In the UK, for example, institutional investors own around 80% of the UK stock market (see below for further detail). In the US, the figure is less, but institutional investors are very powerful in absolute terms.

- Thirdly, institutional investors are increasingly seeking to diversify their portfolios and invest overseas. They then look for reassurances that their investment will be protected.

- Fourthly, with technological advances in communications and markets generally, ideas can be disseminated more widely and more quickly, and institutional investors globally are talking to each other more and forming common views on key aspects of investment such as corporate governance.

- Fifthly, given that businesses as diverse as family owned firms and state owned enterprises are increasingly seeking external funds, whether that is from domestic sources or international sources, corporate governance takes on an increasingly important role in helping to provide confidence in those companies and hence help to obtain external funding at the lowest cost possible.

- Finally, within a country (as opposed to a company or individual business), good corporate governance helps to engender confidence in the stock market and hence in the economic environment as a whole, creating a more attractive environment for investment.

Mallin (1994) identified a framework within which corporate governance was developing in the UK. She described this as a triangle of corporate governance influences with the apexes being the institutional investors and their representative bodies, the Cadbury Committee recommendations and the London Stock Exchange as the regulatory element. An update of this triangularisation would include the Combined Code 1998 revised 2003 (in addition to the original Cadbury Code); whilst institutional investors and their representative bodies could also include the reports of Myners (2001) and the Institutional Shareholders' Committee (2003).

3. Main Corporate Governance Provisions in the UK

The Cadbury Report (Report of the UK Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury, former Chairman of Cadbury Schweppes and a director of the Bank of England) was published in 1992 (Cadbury, 1992). Its recommendations were as follows:

- Companies should establish two key board committees: audit – composed of non-executive directors (NEDs), responsible to the board; remuneration - responsible to the board for recommending remuneration of directors. In addition, a nomination committee is suggested as a way to help ensure a formal and transparent procedure for the appointment of new directors to the board.

- There should be at least 3 independent NEDs and board balance meaning a balance of executives relative to NEDs so that no individual can dominate the board's decision making.

- Separation of roles of Chair (running of the board) and CEO (executive responsible for running the business).

A key element of corporate governance is the appointment of independent non-executive directors by an appropriate process (the nomination committee being one suggested mechanism). The definition of independence could take up many pages of discussion but in a nutshell, the Cadbury Report states that non-executives [being] independent of the company, means 'that apart from their directors' fees and shareholdings, they should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment'.

The Greenbury Report (1995) focused on executive remuneration whilst the Hampel Committee (1998) reviewed the corporate governance recommendations in force in the UK at that time. The recommendations of the Turnbull Report (1999) were concerned with the management of internal controls and risk.

The Combined Code (1998) was revised in 2003 to take account of various corporate governance developments in the UK and globally. It has two main parts: one on companies and one on institutional shareholders. The part on companies contains sections on directors, remuneration, accountability and audit, and relations with shareholders. In relation to directors, the Combined Code states that there should be an effective board, which is collectively responsible for the success of the company and a clear division of responsibilities at the head of the company (separation of the roles of Chair and CEO).

The inclusion of a balance of executive and non-executive directors (and in particular independent non-executive directors) on the board will help prevent an individual becoming too dominant, and a formal, rigorous and transparent procedure for the appointment of new directors to the board should help ensure that the most appropriate people are appointed as directors. Information should be provided to the board in a timely manner to enable it to make informed decisions, and all directors should regularly update their skills and knowledge. A formal and rigorous evaluation should be carried out annually of the board's performance and

that of the committees and individual directors. Finally all directors should be put forward at regular intervals for re-election (as long as their performance remains satisfactory).

In relation to remuneration, the Combined Code states that 'levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully'. Regarding accountability and audit, the board should give a balanced and comprehensible assessment of the company's position, and should maintain a sound system of internal controls. The board should establish an audit committee of independent non-executive directors.

Appertaining to relations with shareholders, there should be 'a dialogue based on the mutual understanding of objectives'. Whilst there should be ongoing dialogue between the companies' directors and its major shareholders, the annual general meeting is seen a means of communicating with investors generally and encouraging their involvement.

The Combined Code (2003) recommends that institutional investors should have a dialogue with companies based, as previously mentioned, on the 'mutual understanding of objectives'. Institutional investors are encouraged to take all factors into account when assessing a company's corporate governance (for example, smaller companies often have fewer independent non-executive directors). As with earlier UK corporate governance codes, institutional investors are exhorted to make considered use of their votes.

Of course as well as the corporate governance developments and the drivers that have led to these, it is essential to consider the framework within which these have developed. An essential part of this framework is the role of institutional investors in the stock market and, as a result, their potential influence.

4. The Role of Institutional Investors in the UK

The Cadbury Committee (1992) viewed institutional investors as having a special responsibility to try to ensure that its recommendations were adopted by companies, stating that 'institutional shareholders in particular ... should use their influence as owners to ensure that the companies in which they have invested comply with the Code' (p. 54). Similarly, in the

report of the Hampel Committee (1998), it is stated that 'it is clear ... that a discussion of the role of shareholders in corporate governance will mainly concern the institutions' (p. 40). Therefore, the most influential committees' reports (now embodied in the Combined Code)

that have reported on corporate governance in the UK clearly emphasise the role of institutional investors. It is very clear from the aforementioned reports that the potential of institutional investors to exert significant influence on companies has clear implications for corporate governance, especially in terms of the standards of corporate governance adopted and the extent to which issues are enforced. On the other hand, it is necessary to consider that many institutional investors are portfolio investors with financial expertise as opposed to industrial expertise. The latter is required to develop and evaluate corporate strategic decisions, while financial expertise is best suited for analysing financial data released by firms and government agencies. Nevertheless, there is clearly an important role for institutional investors in corporate governance. This role is discussed next.

The shareholder composition varies tremendously across the world. In the UK and the US institutional investors have become very important over the last thirty years as their share ownership has increased and they have become more active in their ownership role. Institutional investors tend to have a *fiduciary responsibility*, this is the responsibility to act in the best interests of a third party (generally the beneficial, or ultimate owners of the shares). Until recently this responsibility has tended to concentrate on ensuring that they invest in companies that are not only profitable but which will continue to have a growing trend of profits. Whilst this remains the case, governments and pressure groups have raised the question of how these profits are achieved. We now see institutional investors being much more concerned about the internal governance of the company and also about the company's relationship with other stakeholder groups including society as a whole.

The latest statistics produced by the ONS (2003) on UK Share Ownership as at 31st December 2002 highlight that institutional investors own around 80% of UK equity, with the largest holdings being those of insurance companies 20%, pension funds 16%, and overseas investors 32%. Clearly institutional investors have the ability to exercise significant influence in UK corporate governance developments.

In his seminal work, Hirschman (1970) identified the exercise of institutional power within an 'exit and voice' framework; he argued that dissatisfaction could be expressed directly to management, (the *voice* option), or by selling the shareholding, (the *exit* option). The latter choice is constrained by the size of institutional investors' holdings and their policy of maintaining diversified balanced portfolios. Myners (1995) emphasized the role that institutional investors should play in an investee company and outlined the way that a 'model' company and a 'model' institutional investor might relate to each other. The meetings

between institutional investors and companies were seen as an extremely important means of communication between the two parties and this was emphasized by Mallin (1994) in her paper on the role of institutional investors in corporate governance, where she highlighted the role of one-to-one meetings between institutional investors and their investee companies. Mallin (1997) analysed the institutional investor ownership of financial institutions in the UK and also the adoption of key corporate governance structures in financial institutions and found that the life assurance companies had the highest level of adoption of key board committees (audit, remuneration, nomination committees) whilst the retail bank sector had the highest proportion of non-executive directors.

The Myners Report (2001) recommended that fund managers should be more active, so that, for example, reservations about strategy, people or other potential causes of underperformance (or loss of value) should form the basis for greater intervention.

Recently there have been pronouncements by the Association of British Insurers (ABI) and National Association of Pension Funds (NAPF); and the Institutional Shareholders' Committee (ISC) about institutional investors and their role in corporate governance. The ISC (2002) issued a statement on the responsibilities of institutional shareholders and stated that the policies on activism that they describe 'do not constitute an obligation to micro-manage the affairs of investee companies, but rather relate to procedures designed to ensure that shareholders derive value from their investments by dealing effectively with concerns over under-performance. Nor do they preclude a decision to sell a holding, where this is the most effective response to such concerns'. In other words, the exercise of 'voice' is recommended but 'exit' is not precluded.

The ISC recommends that institutional shareholders should have a clear statement of their policy on activism and on how they will discharge their responsibilities; monitor performance; intervene when necessary; and evaluate and report on the outcomes of their shareholder activism.

The increased pressure on institutional investors to become actively involved in corporate governance blurs the distinction between these investors and "strategic investors" which traditionally play a major role in continental corporate governance systems. We return to this issue below.

5. The Role of Auditors

Echoing the debate in the US, the UK Treasury has also commissioned a report on conflicts of interest between auditing and consulting within accounting firms and the reporting committee is also considering the merits of revolving auditors. These areas have caused considerable debate amongst the various interested groups including companies, investors and the auditors themselves. Issues of auditing and conflicts of interest have become major concerns on the Continent as well. We return to these issues in the next section wherein we discuss the role of financial markets and institutions in corporate governance.

6. The Financial Sector and Corporate Governance

It is clear that the financial sector has a major role to play in corporate governance. Banks in 'Continental' Europe (CE), as lenders to SMEs and 'Mittelstand' companies have traditionally played a major role in corporate governance through equity-holdings, cross-shareholdings and reciprocal board membership. In contrast, UK banks have not been major shareholders. Instead, pension insurance and mutual funds' are more highly developed reflecting the more important role hitherto played by the capital market in the UK. Shareholder activism has however, only recently begun to emerge as a significant force in the UK. As noted above, this is being encouraged by the Institutional Shareholders Committee and the UK government is considering making voting by fund managers at shareholders meetings compulsory. Thereby, institutional shareholders in the UK take on some of the roles "strategic investors" have in CE. Hitherto, the threat of hostile takeover through mergers and acquisitions has been seen as the main conditioning force in the UK. The CE approach has been to manage restructuring through friendly negotiations among strategic investors with controlling ownership-stakes in the firms while avoiding contested 'mergers' and costly bankruptcies. Control cannot be threatened directly in the market place because of the existence of take-over defenses in the form of, for example, differentiated voting-rights for different classed of shares. These strategic investors can be thought of as "insiders" in the corporations while institutional investors traditionally have been "outsiders". The corporate governance codes in the UK can be thought of as instruments of making "outsiders" taking on the role of "insiders" in CE.

Until recently it seemed that there was a process of convergence underway (Mullineux, 2003). The US (and Japan) would allow European style universal banking (combining commercial and investment banking) and bancassurance (combining banking and insurance) whilst capital markets would increase in importance in CE driven by privatization of industry (especially 'utilities') and pensions. This in turn would lead to a growth in importance of pension,

insurance and mutual funds as institutional investors in place of strategic investors with close links to the large universal banks. Concerns about conflicts of interest in investment banking, especially in the US and the UK, have however challenged the viability of the universal banking model. Particular issues include the independence of research reporting to investors and the possibility that shares have been placed cheaply with favoured clients who might well feel disposed to buy other services from the bank in the future. There is also the issue of commercial banks using cheap loans and credit lines as loss leaders to clients who may be induced to buy more complex investment banking services from the vendor as a result. It is unclear as yet whether judicious use of 'Chinese walls' and separately capitalized subsidiaries ('firewalls') will suffice, or whether the potential conflicts should be eliminated by more root and branch reform. Experiences in the USA indicate that conflicts of interest are merely the mirror image of synergies in conglomerate financial institutions.

To perform its corporate governance function effectively, the financial sector itself must be efficient. Given the numerous fiduciary duties involved and that the very existence of the sector is based on information asymmetries and economies of scale, it is naturally one of the more heavily regulated. Hence ultimately, the establishment of an efficient corporate governance system requires the establishment of a competitive and efficient financial sector subject to regulation and supervision to protect the economy and wider society from systemic failures. The objectives of competition in the financial sector, which contributes to reducing the scope for conflicts of interest, may be inconsistent with regulation and supervision to achieve "stability" reducing systemic risk. The implementation of the Basel II capital adequacy framework is likely to increase concentration in banking and the financial sector as a whole. If competition thereby is reduced an important market check on conflicts of interest is weakened.

Naturally, when the efficiency and stability of the financial system is called into question, as in post bubble Japan, and post bubble (and Enron and WorldCom) US, (and as in the possibly soon to be post housing bubble UK) and in light of the Asian, Russian, Brazilian, Turkish and Argentinean *inter alia* banking and wider financial and economic crises, the effectiveness of the regulatory and supervising system is called into question. This in turn leads to periodic overhauls. New rules in turn encourage circumventary innovation and periods of stability encourage laxity, or worse 'capture'. As the global financial system develops, the appropriate regulatory and supervising system for the financial sector itself evolves in an uncertain environment.

The extent to which the market can be relied upon to condition corporate behaviour is now, of course, hotly debated post Enron. More disclosure, as suggested in both corporate governance

codes for corporations and Basel II for banks, is only useful if the information disclosed is accurate and reliable. Accounting and auditing standards[1], as well as other disclosure rules in general affect both accuracy and reliability, but if information disclosure requirements are not also conforming with firms' and banks' incentives to disclose information the efficacy of rules and requirements can be questioned. We want to elaborate on this point.

Under asymmetric information when there are opportunities to exploit information advantages there are still incentives for some "high quality" market participants to reduce the information gap through disclosure and signalling mechanisms. For example, the management that does not extract private benefits wants the market to know this. Similarly, the financial institution that benefits from synergies between corporate advisory services and financial research or brokerage without exploiting information for its own or particular clients' benefits would want clients to know this. The bank that is particularly prudent in its risk taking and contractual enforcement would like investors to know. On the other hand, there are always a number of firms and financial institutions exploiting information advantages. Their management teams naturally want to avoid information about their behaviour being revealed. In a competitive environment the "high quality" firms have an incentive to help reveal the true nature of those hiding information. Thus, disclosure rules are most important in non-competitive environments. If disclosure rules are inconsistent with the information disclosure incentives of the "high quality" firms and banks as well, all market participants have the incentive to limit information disclosure to a minimum or they have the incentives to disclose in a less than truthful manner. In general, there are ways to disclose in such a way that information remains opaque.

The implications of this discussion is that for information disclosure requirements to be effective they should be "market conform" in the sense that requirements are consistent with the incentives to disclose by high quality firms. Furthermore, encouragement of a competitive environment is likely to be at least as important for information revelation as disclosure requirements.

One way in which the financial sector plays a key role in assuring good corporate governance is by creating competition among firms for the funds available in the capital markets. Through competition an efficient allocation of capital on a continuous, dynamic, basis should be achieved. This involves continuous portfolio adjustment and re-allocation of capital.

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[1] There seems to be a new impetus to the development of such standards under the auspices of the International Accounting Standards Boards, post Enron.

An interesting question is how the CE and the UK corporate governance systems differ in their incentives to disclose information of various kinds. On the face of it, the firms in a system relying more on a competitive process for external funding of projects would be more inclined to disclose information, if the institutions supplying funds are also competing both for clients and for the wealth of households. The CE system has traditionally relied more on private information channels between firms and financial institutions, but if there are competing institutions then again there is one level requiring public information disclosure. The weakness of the CE system is most pronounced if the conglomerate financial institutions are able to limit competition among themselves and with alternative sources of external finance. The weakness of the UK system is most pronounced if the private information of managers is not made available to outside investors or their agents, i.e. institutional investors.

The "globalization" of financial markets can be viewed as efficiency enhancing to the extent competition among financial institutions and among firms is increasing. However, 'globalisation' also has its critics and as a result of the successful campaigning of anti-poverty and environmentalist activists new dimensions are being added to corporate governance and the responsibilities of institutional investor. In the UK and the US in the 1990s, ethical or socially responsibility investment funds attracted investors willing to forgo some financial return if compensated by more environmentally or socially responsible investment (SRI). In many cases the financial performance of such funds was not much different from mainstream funds, at least during the prolonged stock market upswing. This in turn has encouraged companies to pay more attention to corporate social responsibility (CSR) and environmental issues, leading to indices being developed to rank companies according to their performance in these non-financial spheres, and in some cases to 'triple-bottom line' auditing of financial, social and environmental performance. Indeed UK pension law enacted in 201/2 required pension funds to state their SRI policy, even if they merely state that they do not have one (which is increasingly regarded as likely to be bad public relations). The UK government is reportedly considering requiring all institutional investors to state their investment policies and explain their voting behaviour (or lack of it) at corporate shareholder meetings.

Much of the debate about financial systems and corporate governance is focused on shareholder rights and shareholder influence on corporate behavior. However, much control over management behavior is exerted through bank and other forms of debt. The incentives of debt-holders to influence corporate behavior depend to a large extent on their rights in case of distress. Therefore, bankruptcy laws are a key component of any corporate governance system. The banks will only lend if they can get their money back, and bondholders take a

similar view. In this sphere too there is plenty of room for debate and interesting contrasts. The recent UK Enterprise Bill aims to encourage entrepreneurship by improving the rights of 'good' as apposed to 'recalcitrant' business debtors, relative to creditors; as a means of encouraging entrepreneurship and reducing the fear and stigma attached to business failure in the UK. One may ask whether stronger debtor rights in bankruptcy serves these objectives. The strongly creditor- and contract oriented UK bankruptcy law is known to encourage informal restructurings, while the more debtor-friendly, statutory US law discourages informal restructurings based on prior contractual arrangements.[2] (Franks and Sussman, 2000)

In the US there are proposals to tighten bankruptcy laws in favour of creditors. It is clearly not easy to strike the correct balance between creditor and debtor orientation. Too lax a law is likely to increase bank credit rationing to small businesses, especially start ups, and increase risk premia changed. To tight a law is likely to discourage risk taking. However, predictability of outcome would seem to be enhanced by a contractual approach as in the current UK system, as long as the banking system is competitive. Thereby, the risk of abuse of power by banks is reduced.

7. US and EU reform proposals

In the US, the Enron debacle has *inter alia* triggered a number of legislative initiatives (such as the Sarbanes-Oxley Act of July 2002). In the EU a report by "the High Level Group of Company Law Experts" on corporate governance reform was issued in November 2002. One motivation for the report is to "co-ordinate and strengthen efforts undertaken by and within Member States to improve corporate governance". The immediate objectives are improving shareholder protection and restoring confidence in the system, which was shaken by the recent events. In the longer term the objective is to improve the efficiency and competitiveness of EU firms, aiding in the development of the Single Market and facilitating and empowering growing cross border investment.

The High Level Group's recommendations are clearly inspired by the developments in the UK. However, it recognizes that there is great diversity in company law and other areas affecting corporate governance within the EU and the diversity will increase further with enlargement in the next few years. It is therefore of great importance for the EU to develop procedures for corporate governance reform recognising this diversity among states.

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[2] See Franks and Sussman (2000) and Wihlborg and Gangopadhyay (2001)

One group of proposals refer to *disclosure* of information related to corporate governance. The High Level Group proposes EU wide disclosure requirements for listed companies (although detailed rules would be set in Member States) referring to information about key elements of corporate governance rules in an annual statement, remuneration of directors, the costs of compensation schemes, the independence of directors and their qualifications, and group structures.

A second group of proposals refer to the adoption of an EU recommendation strengthening the role of *independent directors* in audit, nomination, and remuneration committees as well as on the Board. Criteria are laid down for the independence of directors. There is a risk that the High level Group's proposals for stringent rules for board members qualifications and responsibilities may discourage qualified individuals from board membership in some EU countries, and such rules could cause difficulties in countries where creditor and labour representatives are normally members of the board.

The third group of proposals refer to EU support for national rules with respect to responsibilities of institutional investors to disclose investment policy and the exercise of voting rights, with voting strategies published and individual votes disclosed to beneficiaries of the institutional investor on request. These proposals are based on an assumption that self-regulation of institutional investors has proven insufficient in the light of their passivity in the face of management failure and lack of information to beneficiaries. The European Shadow Financial Regulatory Committee (2002) have gone further and recommended that institutions be obliged to publish ex post a list of their votes in company meetings for their beneficiaries to examine. The Committee argues that this would shame those passively voting for management, and allow investigation of conflicts of interest. On the other hand, there is a danger that funds become obliged to take positions in areas where they do not have expertise. Going too far in the direction of requiring institutional investors to act beyond their capabilities would violate the principle of market conform regulation discussed above.

Finally, the High Level group suggests EU wide rules for responsibility of board members for financial statements. This issue is a case where self regulation alone has proven insufficient but one may question whether an EU Directive is needed since collective responsibility is already enshrined in national legislation.

Mallin (2004) details recent developments in corporate governance in the US and the EU including the New York Stock Exchange Corporate Governance Rules (2003) and the EU's 'Modernising Company Law and Enhancing Corporate Governance in the EU' published in

November 2003 which largely incorporates the recommendations of the High Level Group of Company Law Experts discussed earlier. In addition the OECD has recently issued revised principles of corporate governance in the Spring of 2004.

The Swedish Commission on Business Confidence issued a report in May 2004 emphasising improved corporate governance, increased confidence in the financial sector, and a more effective competition policy. Although in most respects inspired by the UK and EU principles discussed above, the Swedish Commission deviates or goes further in some areas. The Company act should require that decisions with respect to remuneration principles and incentive programmes are taken at shareholder meetings. Companies covered by a "Code of Corporate Governance" (CCC) can deviate from the code under the principle "comply or explain". There are rules for increased involvement by institutional investors but the commonly used differentiated voting rights are left untouched.

Most far reaching are the proposals with respect to accounting and auditing. It is proposed that these matters are put under a new "accounting supervisory authority" that will oversee accounting in unlisted companies, accounting in listed companies, and auditing in the same way the Financial Supervisory Authority oversees financial institutions. Standard setting would be handled by a panel obtaining its mandate from the new authority.
There are two dangers with such an upgrading of requirements in accounting and auditing. First, there is a danger that firms that do not reveal important information while abiding by the supervisors requirements may avoid responsibility for consequences of insufficent information disclosure. Second, a new bureaucracy subject to political influences is created.

The Swedish proposals for increased competition refers primarily to product markets and not to the financial industry. Thus, they do not provide a counter-weight to the likely competition reducing consequences of Basel II.

8. Concluding Comments

The adoption of internationally accepted accounting and auditing standards has helped ensure that the UK has a high level of transparency and disclosure in the corporate and financial sectors. Building on the sound foundations of the Cadbury (1992) recommendations, corporate governance has evolved through a series of far reaching reports including the Greenbury, Hampel, Turnbull, Myners, Higgs and Smith reports. The revised Combined Code issued in July 2003 has carried on this tradition of a robust framework for corporate

governance, whilst institutional investors have been active in setting their agenda for active share ownership in the companies in which they invest.

The UK principles for corporate governance seem to be market conform in the sense that the stipulate behavior consistent with incentives of management of “high quality firms” which do not try to exploit information advantages. Whether the same principles are market conform in the Continental EU with its different ownership structures and stronger roles for strategic controlling owners and associate banks is not obvious.

We have argued that competition in both product and financial markets is important for appropriate market incentives in corporate governance to develop. Without such incentives codes of conduct and even legislation are likely to be ineffective. In this light it is unfortunate that the proposed capital regulation for banks in Basel II is likely to reduce competition in the financial sector. The UK stock market financial system is likely to be less influenced than the bank dominated Continental systems. Finally it is worth mentioning that it is clearly worth debating the issue of whether the US should follow Sweden, the UK, Japan and now Germany in establishing a single (non-central bank) regulatory agency (built around the SEC?) in this age of financial conglomerates. That is unless the conglomerates themselves have become dinosaurs or globalisation makes country based financial regulation and supervision redundant (even in the US!)

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