

# **Competition in Company Control**

**A Shareholder-Driven Alternative to the  
Higgs Proposals on  
Non-Executive Directors**

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## **Bibliographical information**

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## The Higgs Review

Amongst the events that predictably lead to demands for government action are business failures and corporate scandals. Demands for government action to improve corporate governance are, however, based on a dual mistake. They wrongly presuppose that the problems have been caused by a lack of sufficient regulation, and they erroneously assume that government regulation can make things better.

In April 2002, in response to the Enron and WorldCom scandals in the US and Marconi in the UK, the UK government instituted the Higgs review of the Role and Effectiveness of UK Non-Executive Directors. Its terms of reference reassuringly stated that the government's "preferred starting-point in this area is, if possible, an approach based on best practice, not regulation or legislation".<sup>1</sup> Experience has shown, however, that all such pronouncements need to be considered sceptically. Best practice rather than regulation may indeed be the government's publicly preferred *starting point*. But judging from their past performance, it is unlikely to be the preferred – or the actual – *outcome*.

Higgs's own pronouncements sensibly acknowledge that legislation is not the answer. In recommending an extension of the 'comply or explain' regime of the Combined Code, he explicitly states that explanation should be as important as compliance.<sup>2</sup> But even Higgs calls for enforcement of his 'best practice' guidelines by the Financial Services Authority,<sup>3</sup> a government agency with sweeping powers (though less accountability), and for a further official review in two years.<sup>4</sup> The danger of 'regulatory creep', in which guidelines are transformed over time into mandatory requirements, is all too real.

The likelihood of regulation is exacerbated because many of the respondents who participated in the Higgs review regularly advocate regulatory strictures. Some seek government regulation to make directors serve a social or political agenda other than the direct interests of shareholders. Others, including many who ostensibly represent business interests, would enlist government support to prescribe some favoured model of best practice, regardless of shareholders' own preferences.<sup>5</sup>

Both such approaches are mistaken: *by its very nature, corporate governance should be the responsibility of the shareholders themselves*. There is much that could and should be done to increase the effectiveness of non-executive directors, but *it should be up to the shareholders of each corporation to determine the rights and responsibilities of their directors, both executive and non-executive*.

It is notable that those who claim that active corporate governance interferes with the efficient working of corporations are usually senior corporate executives. In evaluating their claim, it is essential to remember that *a key purpose of corporate governance is precisely to prevent managers from pursuing their own interests instead of those of the shareholders*. When managers perceive corporate governance as interference, it may well be a sign that the managers are pursuing the wrong objectives; if they are, then interference is right and proper. A similar argument

applies to charges that having powerful non-executives is 'divisive'.<sup>6</sup> It is better to have at least one division of the board championing the interests of the shareholders, than to have a board that is united against the shareholders' interests.

A genuine problem would exist if corporations' legitimate activities were hindered by corporate governance-inspired attempts to monitor them. When that happens, however, the culprit is not corporate governance but bad judgement. Since the purpose of corporate governance is to promote achievement of the corporate objective, the amount and type of monitoring must be consistent with that purpose; monitoring that undermines achievement of the corporate purpose is self-defeating. The way to prevent counterproductive monitoring is to ensure that all concerned are committed to the corporate objectives.

## **The Meaning of Corporate Governance**

The role and effectiveness of non-executive directors in governing the corporation can only be evaluated sensibly if the meaning and purpose of corporate governance are clear. Properly understood, corporate governance refers to *ways of ensuring that corporate actions, agents and assets are directed at the constitutional objectives of the corporation, those set by the corporation's owners, the shareholders.*<sup>7</sup> It should therefore be up to the shareholders of each corporation to specify what kinds and degrees of accountability they require, and how they want to achieve it.

Insofar as the external imposition of corporate governance regulation seeks to prevent shareholders from organising their own corporations in their own ways, it is necessarily counterproductive. *Reform proposals that might well be sensible for many companies are inappropriate when presented as prescriptions for all. The degree and sort of accountability wanted, and the mechanisms most suited for achieving that accountability, will appropriately reflect each corporation's particular objectives, history, size, activity, jurisdiction and shareholder composition. One size will emphatically not fit all.*

The belief that it will, typically, results from insufficient clarity about the nature of corporate governance. Too often, this concept is employed very loosely; it is used to refer to everything from the state of the economy to the regulation of organisations that are not even corporations. Understanding it strictly, however, avoids these confusions. It also provides the solution to one of the continuing disputes surrounding the main duty of directors: whether they should focus on corporate accountability or on corporate performance. As the strict characterisation reveals, both components are essential: directors are properly accountable *to* shareholders *for* achieving the corporate objectives.

Significantly, the strict definition of corporate governance also provides a criterion of good corporate governance. *The more that a corporate governance system or mechanism enables shareholders to establish their corporations' objectives, and helps shareholders to ensure that corporate actions, agents and assets are directed at those objectives, the better the system or mechanism is.*

## **The Importance of the Corporate Objective**

The ability to specify corporate objectives is essential. Historically, one of the advantages of the corporate form is that it has been usable for a wide variety of purposes – personal, educational and charitable as well as commercial. Despite a common belief to the contrary, not all corporations are businesses, and most businesses are not corporations. Whereas 'corporation' designates a particular organisational structure, 'business' designates a particular objective;<sup>8</sup> that of maximising long-term owner value by selling goods or services<sup>9</sup>. In England, under a third of businesses are corporate in form,<sup>10</sup> and fewer than one in a thousand have shares listed on the Stock Exchange.<sup>11</sup>

If the corporate purpose is not necessarily business, what is it? Though the personal and institutional objectives of shareholders can be as diverse as they are, *the corporate purpose is easy to identify: it is properly that which is set out in the corporation's Memorandum of Association or comparable constitutional document.*<sup>12</sup>

Some people may object that such official corporate purposes are now largely irrelevant. Most corporations have objects that are so broad as to permit them to do almost anything. And in any case, most corporations also do much else besides (they are, for example, obliged to act as unpaid tax collectors). *Ultra vires* has effectively been abolished, and the government has eliminated the 'Objects' clause from its new model corporate constitution.<sup>13</sup>

The official corporate purpose remains important, however, because it creates expectations and establishes limits. If a corporation solicits stakeholder participation on the basis of being a business, it creates legitimate expectations that it will be run as a business, and not as a charity. Similarly, if a charitable corporation collects funds for famine relief, contributors have a legitimate expectation that those funds will be used for alleviating starvation and not for subsidising opera. They are entitled to think so, because corporate purposes determine which activities are legitimate for the corporation.

The official corporate purpose is also crucial to corporate governance. When ownership is detached from management, managers may be disposed to run corporations to serve their own ends rather than the owners'. Mechanisms are needed, therefore, to make sure that it is the shareholders' interests, as defined by the constitutional corporate objective, that govern the corporation and all its actions and agents. *Ensuring adherence to the corporate objective is the essence of corporate governance.*

## **Directors' Responsibilities**

The corporate objective is, accordingly, central to the board's definitive responsibility. According to Higgs's proposal for the Combined Code,<sup>14</sup> "The board is collectively responsible for promoting the success of the company by directing and supervising the company's affairs." But it is only by reference to the corporate

objective that the 'success' of a corporation can sensibly be established. *The board's responsibility is to direct the corporation to achieving the corporate purposes established by the shareholders.*

To that end, the board must, *inter alia*, set policy in accordance with shareholder objectives, authorise key corporate decisions, appoint senior executives and auditors, nominate directors,<sup>15</sup> monitor corporate and executive performance, and determine executive remuneration. The board must also establish and monitor internal control systems to ensure that corporate actions that are not taken directly by the board are nonetheless legal and are directed at achieving the corporate objectives.

In order for directors to be equipped to keep corporations to their proper ends, four conditions must be met:

- the *distinctive responsibilities* of directors must be recognised;
- directors must be *properly qualified* to perform their role;
- directors must be structurally *independent of management*; and
- directors must be *properly accountable to shareholders*.

*The distinctive responsibility of a director is to direct the corporation so as to achieve the shareholders' objectives.* The responsibility of the executives, in contrast, is to execute the directors' strategy. Though in practice the directors of firms are often the senior managers of those same firms, the responsibilities they have as operating executives and as directors are conceptually distinct. All directors, however, have the same responsibilities in their capacities as directors, whether or not they are executives of the corporation they direct.

*The role of the director incorporates elements of representative and steward, trustee and watchdog.*<sup>16</sup> As an artificial person, a corporation needs actual people – directors – to represent it. But though the directors represent the corporation, they also represent the shareholders; the corporation is run by the directors, but is the property of the shareholders in aggregate. Directors have a fiduciary responsibility to use the corporate assets and their corporate powers to achieve the objectives of the shareholders. To ensure that those corporate purposes are achieved, directors must oversee the actions of corporate management. Like watchdogs, directors are responsible for identifying problems and raising the alert. Unlike canine watchdogs, however, directors are also responsible for diagnosing and correcting what is wrong.

## **Directors' Requirements: Personal Qualities and Attributes**

*For directors to perform their role properly, they need specific abilities and traits of character other than those often supposed.* Despite what is implied by some commonly used selection procedures, the prime requisite of a director is neither 'clubability' nor having influential contacts. Indeed, since critically scrutinising corporate agents is so essential a directorial function, the desire to be liked can be a positive handicap. This is not to say that social skills are not valuable: to the extent that they help the director do his proper job, they are clearly an important asset. But they are only part of the kit

that an effective director needs.

Equally, the chief qualifications for being a good director are not specific business experience, academic degrees or professional credentials: these may all be good to have, but they are neither necessary nor sufficient for being a good director. Just as managerial ability is distinct from technical expertise, so the qualities needed for being a director are not the same as either. One can be a successful line manager and still lack the focus and moral courage needed for being a director; conversely, one can have little or no experience of a given business and still be entirely capable of acting as an effective steward. A business director must, of course, understand very clearly what business is about; he must understand the financial language of business, and know how owner value is maximised. But such understanding requires critical intelligence, not direct experience of all or indeed any specific business function: it is not necessary to be an accountant to understand financial statements.

*The essential qualities of a good director are those that enable him to ask the questions necessary for safeguarding the owners' interests, and to get and evaluate and act on the answers. The relevant qualities are those of a good steward: integrity, loyalty, sound judgement and moral courage.*

First, do their job correctly, *directors must be committed to achieving the goals of the shareholders.* Directors' loyalty must be to the corporate purpose, not to the managers or the employees or customers, or to any personal or ideological objective. Directors of a business corporation, for example, must both understand and fully endorse the business purpose of maximising long-term owner value.<sup>17</sup> *Directors should not see themselves as representatives of any non-shareholder stakeholding group or corporate function<sup>18</sup>, or even of particular shareholders.* The role of the director is to ensure pursuit of the corporate objectives, not to promote sectional interests.

*This commitment to the company's goals includes having the time to do the job correctly.* However, the time required will depend on the size of the company, the complexity of its activities, the number of directors, and the skills and circumstances of the individual director. All of a prospective director's other commitments, both professional and personal, should be taken into account when appointing board members. Having a seriously ill relative or a demanding job as an executive – at either the same or another corporation – can be as distracting as having another board appointment.

*The second general requirement for directors is sound judgement. For directors of business corporations, both good business judgement and good moral judgement are required.* Business directors must understand what counts as maximising owner value, and appreciate what is likely to bring it about. They must be able to estimate the long-term risks and consequences of corporate actions, and to determine whether corporate actions are compatible with the appropriate ethical constraints.<sup>19</sup> And they must know what information they need to make such assessments and how to get it.

*Finally, directors must have moral courage.* They must understand when and how to challenge management's actions, and when to bring matters directly to the attention

of the shareholders. They must also be ready to act on that understanding. A director who cannot cope with confrontation, who is not prepared to ask hard questions and demand satisfactory answers, is as unqualified for the job as one who does not understand a cash-flow statement. Directors must scrutinise actual and proposed corporate activities, and allow only those projects and policies that conform to the definitive corporate end.

## **Directors' Requirements: Structural Support**

To increase directors' ability to perform their duties effectively, it is appropriate for the corporation to provide them with structural support: directors need independence, information and access to professional advice.

*The independence that is required for directors to perform their function is, above all, independence of management.* Given the importance of directors' supervisory function, and the need for critical assessment of management, it will normally be prudent for most directors to be non-executives, and for the Chairman of the Board not to be the Chief Executive. Increasing the proportion of independent, non-executive directors decreases the likelihood that the board will suffer from structural conflicts of interest.

This is not to say that executives should be barred from being directors by law, or that chief executive officers should be barred from becoming chairmen. It would be absurd if the original founders/owners of a business, who were also its managers, were not allowed to become directors when their business became corporate in form. Nor would it be sensible to deny a business the talents of those exceptional individuals who are fully capable of fulfilling two roles simultaneously or sequentially. But it is usually easier for a director to view the acts of the managers critically if he is not one of them himself, and has no vested interest in defending the status quo. It is also normally easier if neither he nor his immediate family have any business or personal relationship with the firm or its managers. Ultimately, though, independence – like integrity – is a function of character, not of position or timing.

But directorial independence requires substantially more than directors' not being executives of the company. *Genuine independence also requires that the directors' appointment, and their access to information and advice should be independent of the company's management.* Traditionally, agendas are set and board papers are prepared by corporate executives. For directors to be able to perform their supervisory function effectively, however, all directors, including the non-executives, need to have independent access to company information and the company's staff. It will often be appropriate, therefore, for the company to bear the expenses that directors incur in investigating company matters.

*Independence does not require that non-executive directors' remuneration should represent only an insignificant part of their total income.* The belief that it should presumably results from fears that if a director is financially dependent on his director's fees, he will be less likely to exercise independent judgement, and less inclined to do the right thing on behalf of the shareholders. This fear may be justified if the director's



appointment is dependent on the management he must oversee, and if the director lacks the requisite moral character for performing his duties. The right solution, however, is not to decrease non-executives' financial dependence on company performance, but to increase directors' structural independence of the management. When directors are genuinely independent, their rewards can be directly linked to achieving the shareholders' objectives, so that doing what is right for the shareholders is also financially rewarding for the directors.

*Similarly, independence does not require paying directors only in cash, or excluding them from company performance-related pay, profit-sharing or pension schemes: the independence that directors require is independence of management, not independence of results. If management remuneration schemes are determined and approved by directors, then directors' remuneration should, of course, be governed by separate schemes, and require explicit approval by the shareholders. But it is when directors are insulated from corporate performance, and do not directly suffer the consequences of their acts, that they are most likely to act irresponsibly.*

The conflicts of interest that can threaten directorial independence go far beyond those faced by executive directors because of their dual role. Conflicts of interest are so very pervasive, however, that they cannot normally be prevented or regulated without seriously hampering corporate activities or individual liberty.<sup>20</sup> *Conflicts of interest cannot be regulated away; they need to be managed.*

Prudent boards will identify those conflicts most likely to undermine achievement of the corporate objectives, and will seek to insulate potentially affected decisions from being damaged. For matters that are so sensitive that even the appearance of a conflict may be harmful, it may be appropriate for a company to ban specified outside interests, or to have the conflicted director abstain from the relevant decisions. Often, it will suffice simply to require that directors disclose their potentially conflicting interests. It should be noted, however, that individuals who are directors of more than one company are ordinarily subject not just to a conflict of interest, but a conflict of obligation.

In any case, good corporate governance requires more than ensuring directors' independence of management: it also requires that directors be accountable to the shareholders. Properly designed performance-related remuneration can do much to align directors' interests with those of shareholders. In such schemes, the performances that are measured will themselves positively contribute to the corporate objective, and rewards are lagged sufficiently to reflect the consequences of directorial decisions.

Accountability could also be improved by clarifying and limiting the corporate purposes which directors are empowered to achieve. In business corporations, for example, directors might be required to focus on maximising long-term owner value, and restricted to means that were compatible with the appropriate ethical constraints. The best way to ensure accountability, however, is to ensure that the right directors are appointed.

## Selecting Non-Executive Directors

But are there sufficient paragons both able and willing to accept the full burdens of board membership? The problem of finding directors is likely to be exacerbated if regulatory restrictions (e.g., definitions of independence) exclude candidates who might previously have qualified: in the wake of Sarbanes-Oxley, for example, shortages have already been reported in the US.<sup>21</sup>

*Contrary to popular belief, the best way to redress the shortage of good directors is not simply to recruit directors from more diverse sources.*<sup>22</sup> Certainly, it would be bad business to ignore any properly qualified candidates, whatever their personal characteristics or backgrounds. But seeking diversity for its own sake is triply misguided:

- First, it presupposes the mistaken notion that representatives need to resemble their constituents in order to represent them authentically.
- Second, and even more fundamentally, it ignores the fact that what the director is meant to represent is not any particular sectional constituency, but the interests of the shareholders as a whole, defined by reference to the constitutional corporate objective.
- Third, if 'widening the pool' means appointing people without the requisite personal or professional qualities, then 'wider' will almost certainly mean 'worse'. *Simply being a member of a group not often found on boards does not qualify an individual for the onerous responsibilities of being a director.* And coming from a group that is unwilling or unable to commit to the corporate objective should be an immediate disqualification.

*A better way to ensure the availability of adequate numbers of directors, including non-executives, is to have many different routes on to the ballot.* Shareholders should have the right not only to approve the directors, but to nominate them. Posts could be advertised, and would-be nominees permitted to propose themselves. (Frivolous candidates could be excluded by requiring nominations to be supported by a set number of shareholders, or by requiring candidates to have a minimum shareholding, or by having candidates forfeit a deposit if they failed to secure a certain level of votes. Indeed, such barriers could be made substantial, as a way of guaranteeing the candidate's commitment to the corporate purposes.) To assure that no qualified candidate was excluded from consideration, the basic expenses of electing directors could be paid by the company: it is in the shareholders' interest to get the best directors possible.

Electing directors is most likely to protect shareholder interests when two further conditions are recognised. *First, the competition for board membership is more likely to result in suitable directors if it is based explicitly on the candidates' perceived abilities to promote the corporate objective and protect shareholder interests.* Shareholders may thus want prospective directors to compete on the basis of their strategic and tactical plans for the corporation, their professional and moral judgement, and their independence of and ability to direct management. *Second, elections can be made more useful by holding them often:* frequent elections make it easier to chastise and remove errant directors. Achievement of the corporate objective is most likely to be

maximised when immunity is minimised. Shareholders seeking to maximise accountability will therefore elect directors only for short, fixed terms of office,<sup>23</sup> and will insist on vetting all elements of their remuneration.<sup>24</sup>

## **Regulation, Regulation, Regulation**

*When shareholders are free to act for themselves, it is counterproductive for government to intervene: regulation typically does more to impede good governance than to promote it.* Regulation is necessarily inflexible, and imposes substantial costs, in terms of both funds and freedoms: even disclosure is not costless. Regulations frequently have consequences that are unintended, damaging and difficult to correct; regulation is indeed often positively self-defeating.<sup>25</sup> And laws made in response to perceived crises and hard cases are notoriously defective.

Examples of regulation producing more harm than good are regrettably commonplace. In particular, regulation intended to benefit investors routinely handicaps corporate governance. UK insider trading regulation encourages investors to refrain from acquiring information about their investments, lest they become contaminated and unable to trade. The Takeover Code, meanwhile, discourages investors from acquiring a large enough stake to exercise effective company control. Increased legal penalties for directors have already spurred demands for reducing directors' liability,<sup>26</sup> not least by the Higgs Report itself.<sup>27</sup> And if voting were mandatory, the support of incumbent managements by inertial and uninformed votes would make reform by shareholders even more difficult.

Regulation also constitutes an inherent moral hazard. *In seeking to make equity investment 'safe', regulation tends in fact to make it more dangerous, by providing a perverse incentive for investors to be less diligent and less vigilant.* Defining independence in terms of official roles, preventing chief executives from becoming chairmen of their companies, specifying formal standards for directorial performance reviews, capping the numbers of directorships held by any one individual, and requiring specific directorial training or credentials are all likely to create a false sense of security among investors. Such measures would also limit the pool of potential directors, without ensuring improved corporate governance.<sup>28</sup>

The least damaging sorts of regulations are those which increase the powers of shareholders to choose and implement their own corporate governance mechanisms. Reforms that *empower* shareholders to nominate and directly elect directors, or to vote on their remuneration packages, are more worthy of serious consideration than those which *require* them to do so. Similarly, regulation that describes general principles or default positions, but allows shareholders to opt out, is better than that which provides no alternatives. But although the 'comply or explain' regime of the UK Combined Code is less coercive than simple regulation, even it is contrary to the spirit of good corporate governance.

*Is there any role for government action? Definitely: the most valuable reforms would be those that freed corporate governance from government-imposed burdens<sup>29</sup> and obstacles.<sup>30</sup>* One

positive thing it could do to improve corporate governance would be to fortify the standards and sanctions that underpin trusteeship. The current law already requires trustees to act solely in the interests of their beneficiaries, and for the exclusive purpose of providing them with benefits; but the law is not enforced. Penalising violations of trust law would help strengthen what is perhaps the weakest link in corporate governance, that which exists between institutional investors and the ultimate owners of the assets they manage.

## **The Way Forward: A Genuine Market for Corporate Control**

*But most of the changes that are needed to improve corporate governance do not involve any government action. They can and should be provided by the marketplace itself.* In the US, many firms have already voluntarily chosen to show the cost of granting options as an expense in their profit and loss accounts,<sup>31</sup> and investors are voting down far more option plans than they did five years ago.<sup>32</sup> The best way to bring about beneficial changes would be to encourage maximum experimentation in the marketplace, and to allow different forms of corporate governance to compete for the support of investors.

Contrary to popular belief, the free-rider problem is not an insuperable barrier to such non-regulatory solutions. An investor acting independently would unilaterally incur the costs of action from which all shareholders would benefit. But if the costs of the corporate governance action were for the account of the corporation, they would be automatically shared by all shareholders, in proportion to their shareholdings. Such an equitable association of costs and benefits would result if, for example, the corporation hired the services of specialist organisations to help shareholders identify and nominate directors, or to investigate corporate governance issues, or to vote proxies.<sup>33</sup> Such organisations already exist: consider the (US) Corporate Monitoring Project, and the proxy advisory firms Institutional Shareholder Services, Proxy Monitor, and Investor Responsibility Research Center.

*The kinds and amounts of shareholder support paid for by the corporation could be one of the ways in which companies competed in a genuine 'market for corporate control'.* The 'market for corporate control' conventionally refers to the use of takeovers to transfer corporate ownership.<sup>34</sup> But it can be used more broadly, to refer to the market in which companies compete for shareholders, and investment managers compete for funds, in part on the degree and kinds of accountability they afford to owners and investors.<sup>35</sup>

One form of market for corporate control already exists in the US. There, individual states have long competed to be sites of company incorporation on the basis of the protection they afford to *managements*. The need now is for comparable competition to protect the interests of *owners*. Subjects of such competition might include, for example, the nature of the constitutional corporate objectives, the extent to which strategic and operational matters required shareholder approval, company election procedures, the independence and quality of directors, the extent and quality of performance-related remuneration, and the types of disclosure and audits.

To improve the effectiveness of non-executive directors, companies could compete for shareholders on the different ways in which their directors were *selected and elected*. Companies could experiment with the *levels of disclosure* they required from directors (including their reasons for resignation), with the *personal or professional or other qualifications* they required directorial candidates to have, and with the *number of times that directors could be re-elected*. To align directors' interests with those of shareholders, directorial *shareholdings* of various levels and duration might be specified.

Other experiments could include *varying the responsibilities of the lead non-executive director*, and having *differing percentages of non-executive directors*. Contrary to Higgs's recommendations, a company's unitary board might even be composed entirely of non-executive: executive expertise could be secured via executive committees. Unlike the members of a German supervisory board, such a non-executive board would not necessarily represent factional interests. If its members were explicitly charged with achieving the constitutional corporate objective, and remunerated on that basis, they would have every incentive to avoid factional interference. Once again, the key is aligning the interests of directors with those of the shareholders.

*Corporations might even vary in the extent to which they allowed their directors to be executives of other companies*. Shareholders might seek to employ the services of 'professional directors'<sup>36</sup> – directors who would not be the executives of any firm, but who would be chosen specifically for their ability to safeguard shareholder interests. Even if such directors acted in a non-executive capacity for more than one firm, they might be less prone to the damaging conflicts of interest which now typically arise between executive directors and owners.

Companies could also compete for shareholders on the basis of the *different sorts of financial and structural support offered to directors*. Companies might reimburse some or all of the expenses that directors incurred in investigating company matters, and in taking specialist advice. To align directors' interests with those of shareholders, varying proportions of directors' remuneration could be in the form of shares rather than share options or cash; the period before vesting could be adjusted so as to ensure an appropriately long-term focus. The fact that all directors have equal responsibilities as directors might be emphasised by paying all the directors of a corporation – executive and non-executive – the same directorial fees. Those directors who were also executives of the company, or headed board committees, could be paid separately for undertaking those other responsibilities. Companies could also vary the extent to which directors' (and advisors') liabilities were indemnified, contractually limited, or covered by errors and omissions insurance at company expense.

But these are just a few of the very many different ways in which companies might compete in respect of corporate governance. One of the many advantages of free markets, is that they elicit innovative solutions to problems as they arise in all their real-life variety and complexity. Markets also effectively test those solutions and efficiently disseminate best practice.

*The best way to ensure good corporate governance is to allow shareholders the greatest possible freedom to control their own corporations.* The value of doing so is clear. According to a recent analysis of 1,500 stocks by the (US) National Bureau of Economic Research, companies with the most restricted shareholder rights had annual earnings and valuations between 1990 and 1999 that were almost 9% lower than companies with the fewest restrictions.<sup>37</sup> Shareholder freedom is associated with both good corporate governance and superior corporate performance.

## Notes and References

1. DTI, *Review of The Role and Effectiveness of UK Non-executive Directors: a Consultation Paper*, June 2002, Terms of Reference, Annex A, p.13.
2. Higgs, Derek, *Review of the role and effectiveness of non-executive directors*, January 2003, The Department of Trade and Industry ('*Higgs Report*'), p.3, Covering Letter from Derek Higgs to the Chancellor of the Exchequer and the Secretary of State for Trade and Industry. See also Higgs, Derek, 'Inaccuracies in response to Higgs', Letter to the editor, *Financial Times*, 19 February 2003, p.16.
3. *Higgs Report*, para 17.3.
4. *Ibid.*, para 17.11.
5. Even the Institute of Directors has recommended mandatory reporting against the guidelines of the Combined Code; IoD response to Higgs, p.40.
6. Hill, Andrew and Bob Sherwood, 'FTSE 100 chiefs oppose Higgs reforms', *Financial Times*, 10 March 2003, p.1.
7. And set out in the Memorandum of Association or comparable constitutional document. For a justification, explanation and exploration of this concept of corporate governance, see Sternberg, Elaine, *Corporate Governance: Accountability in the Marketplace ('CGAIM')*, Institute of Economic Affairs, Hobart Paper 137, 1998, especially Chapter 1.
8. And derivatively the activity of pursuing it, and those organisations (of whatever structural form) that have the business objective as their sole or defining purpose.
9. For a detailed justification and explanation of this characterisation of business, see Sternberg, Elaine, *Just Business: Business Ethics in Action* (second edition, Oxford University Press, 2000), especially Chapter 2.
10. In 1997, there were c 3.7 million businesses in the UK, of which over 2.5 million were sole traders or partners without employees. ('Business' was defined as 'a legal unit, person or group of people producing goods or services under their own control'. *Small and Medium Enterprise Statistics for the UK*, DTI, 1997, URN 98/92/ July 1998; quoted in The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework ('Strategic Framework')*, DTI, February 1999, p.182.)
11. Of the 1.32 million companies registered at Companies House at the end of 1997/98, c 12,000 (1%) were public limited companies (Companies in 1997-98, *The Companies Annual Report 1997-98*, The Stationery Office; quoted in *The Strategic Framework, op.cit.* Only about 2,450 public limited companies

have their shares listed on the Stock Exchange; that represents .186% of all the companies that are listed and .066% of all businesses; *ibid*.

12. Unless otherwise specified, all references here to 'official' corporate purposes or objectives, and to 'shareholders' purposes' or objectives' refer to this constitutional purpose; references to 'shareholders' interests' refer to their interests in having the constitutional purpose achieved.

13. Especially considering the vital importance of the corporate objective to corporate governance, it is noteworthy that in its White Paper on Company Law Reform, the government continues to assert that company objects have no 'useful purpose'. DTI, *Modernising Company Law*, CM 5553-I, 16 July 2002, Volume I, Part II, p.17, para 2.2.

14. *Higgs Report*, Annex A.1.

15. Unless shareholders are permitted to do so themselves.

16. This is a conceptual analysis of the role of the director; directors' actual legal status depends on the laws of particular jurisdictions.

17. It is not clear that commitment to the business objective of maximising long-term owner value can be presumed for directorial candidates from the charitable and public sectors.

18. UK titles, e.g., 'finance director', 'marketing director', are misleading: although there may well be some division of labour within a board, and that division may reflect the individuals' executive roles, the directorial responsibilities of all directors are the same.

19. Which are 'distributive justice' and 'ordinary decency' as explained in Sternberg, *Just Business*, *op.cit.*, especially Chapter 3.

20. Consider, for example, the conflict between work and family.

21. Shlaes, Amity, 'On the board, a good man is hard to find', *Financial Times*, 19 November 2002, p.19.

22. As suggested by, for example, the Equal Opportunities Commission, and endorsed by the *Higgs Report*, 'The pool of non-executive directors', paras. 10.15 ff.

23. The campaign by Alastair Ross Goobey, the Chief Executive of Hermes (formerly Postel, Britain's largest pension fund), against three-year rolling contracts for directors was a step in the right direction, but does not go far enough. Cohen, Norma and Maggie Urry, 'Directors cool to plea on contracts', *Financial Times*, 14 June 1993, p.8. Cf. the campaign by Martin Lipton to guarantee directors' tenure for a minimum of five years, the better to protect entrenched managements against takeovers: Lipton, Martin, 'An end to hostile takeovers and short-termism', *Financial Times*, 27 June 1990, p.21.

24. So keen are executives to avoid even the disclosure required in the UK for year-long contracts, that senior UK executives have been known to shorten their contracts on elevation to the main board.

26. For a summary of six ways in which they are, see Sunstein, Cass R., *Free Markets and Social Justice*, Oxford University Press, 1997, pp.271-289. Reprinted as 'Paradoxes of the Regulatory State' in Heath, Eugene, *Morality and the Market: Ethics and Virtue in the Conduct of Business*, McGraw-Hill, 2002, pp.116-25.

26. By, for example, the *Financial Times* (Leader, 8 October 02, p.22), the Chartered Institute of

Management Accountants (Pretzlik, Charles, 'IoD backs British corporate governance model: boardroom review of role of non-executive directors urged not to impose further regulation on companies', *Financial Times*, 5 September 2002, p.4), and the Institute of Chartered Accountants in England and Wales ('ICAEW'; *International Accounting Bulletin*, September 27, 2002, p.6).

27. Para 14.16.

28. According to Halliwell Consulting, it is already apparent that 'the Higgs report ... [is] deterring individuals from becoming non-executives.' John, Peter, 'Boardroom pay levels could soar', *Financial Times*, 10 March 2003, p.3.

29. Including most anti-discrimination, welfare and health and safety regulation....

30. In the US, for example, perverse incentives should be removed from the tax code. Crucially, SEC restrictions that inhibit shareholders from nominating directors should be eliminated. Shareholders should also not be prevented by the law from making proposals that are binding on the board, or from proposing resolutions about corporate elections or the 'conduct of the ordinary business of the corporation'. Directors' duty of care and loyalty should be restored, by rejecting the 'business judgement' rule, and repealing state laws that limit directors' liability. Laws requiring long and staggered terms for directors should also be abolished. When such laws apply, only some of the directors can be replaced at any election; even takeovers can have little effect.

31. Around 120; see Parker, Andrew and Lucy Smy, 'IASB proposes stock option profits deduction', *Financial Times*, 6 November 2002.

32. 23.4% of options plans vs. 16.2%, according to the Investor Responsibility Research Center. Reported in Henry, David, 'An Overdose of Options', *Business Week*, July 15, 2002, Number 3791, p.112.

33. For a detailed description of how this might work, see for example Latham, Mark, 'Collective Action for Dispersed Shareowners' in *Corporate Governance International* (Hong Kong), September 1999; online at [www.corpmon.com](http://www.corpmon.com).

34. The actual market is for securities; corporate control is a function of their ownership.

35. Such a market is recognised by the OECD: 'A market for governance arrangements should be permitted so that those arrangements that can attract investors and other resource contributors – and support competitive corporations – flourish.' OECD Business Sector Advisory Group on Corporate Governance, *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*, Organisation for Economic Co-operation and Development, April 1988, p.34, para 54.

36. See 'Redirecting directors', leader, *The Economist*, 17 November 1990, pp.19-20.

37. Gompers, Paul, Joy Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, NBER Working Paper No. 8449, August 2001.