Does Singapore Need a Code of Best Practices in Corporate Governance?

Loizos Heracleous
Department of Business Policy
National University of Singapore

Introduction

Concerns with the effectiveness and potential abuses of corporate governance are taking global dimensions. Well-publicised corporate collapses and fraud cases are making investors and other stakeholders aware that good corporate governance cannot be taken for granted, and inadequate or ineffective corporate governance can have dire financial and social consequences. Codes of best practice in corporate governance are drawn up by many countries and global institutions, and in many cases compliance statements are made a condition for initial and continued listing by national stock exchanges.

But what is good corporate governance, and does it make a difference to company performance? Can a code of best practice actually improve corporate governance? In particular, does Singapore need such a code? This paper aims to explore these questions, in light of the current wave of interest in these issues in Singapore (Heracleous, 1999a; Phan, 1998; Phan and Mak, 1998; Singh, 1999).

This paper firstly addresses the duties and tasks of directors, emphasising the fact that many directors are not aware of their legal duties as directors, which exposes them to potentially severe penalties. In addition, we draw attention to the fact that boards of directors' actual performance often falls short of normative expectations from boards. Secondly, we discuss the "10 per cent to 100 per cent" paradox, questioning how board members who spend less than 10 per cent of their time with the organisation can make better decisions than managers who spend 100 per cent of their time with the organisation. Thirdly, we discuss what are regarded as best practices in corporate governance, and whether adoption of these practices can lead to improved company performance. Fourthly, we turn to the Singapore context and ask whether Singapore needs a code of best practice for corporate governance. We state that even though there are potent arguments on both sides of the debate, in our view the arguments for introducing such a code

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outweigh the arguments against introduction. Lastly, we conclude with a few thoughts on the development and implementation of codes of best practice. Such codes are not a panacea, but parts of complex arrangements that include institutional conditions, laws, company and industry codes of ethics, and personal morality; but they can have a useful impact in making individuals aware of best practices and encouraging them to attain these practices.

Directors' Duties and Tasks

Most directors are unaware of their legal duties as directors, potentially exposing them to severe penalties. A United Kingdom study by the National Audit Office, for example, showed that about six out of 10 of directors surveyed had not even heard of the Company Directors Disqualification Act 1986. Of those who had heard of it, more than half believed that disqualification arrangements were unsuccessful in deterring unfit conduct; and nearly three quarters believed that arrangements for disqualification were unsuccessful in putting unfit directors out of action and in protecting the public (National Audit Office, 1993). This is consistent with further evidence indicating that managers in general may not be aware of not only legislation, but even the existence of Codes of Ethics initiated by their own industry as a means of self-regulation. Over one-third of a managerial sample from the United States advertising industry was not aware of the existence of the industry code of ethics, and less than one-third of those who were aware said that the code had influenced any decision they had taken over the preceeding year (Maes, Jeffery and Smith, 1998).

In the UK, directors have to carry out the statutory obligations imposed by the various Companies Acts and the Insolvency Act 1986. There are some 200 possible offences for directors under the Companies Act 1985 (Souster, 1991). Delegation of responsibility, or ignorance of transactions entered into by the company, are not adequate defences for a director (which is a point of special relevance to non-executive directors), and courts can require convicted directors to contribute to the assets of the company with unlimited liability. Individuals such as advisors of directors, and executives of holding companies giving instructions to the directors of their subsidiaries, where directors are used to acting under their instructions, can be deemed as "shadow directors" and be liable under this legislation even if they are not formally appointed as directors (ibid). In terms of case law, in addition, directors have a fundamental fiduciary duty to act honestly and in good faith in the interests of the company, and a duty to exercise a reasonable

degree of skill and care in the company's dealings with other parties.

Over 3,000 directors have already been disqualified in the UK on grounds of unfitness to be directors or upon conviction of an indictable offence. Disqualifications were under section 6 of the Company Directors Disqualification Act 1989 dealing with disqualification on grounds of unfitness, section 2 of the Act dealing with disqualification on conviction of an indictable offence, as well as under various other sections of this Act, the Companies Acts 1948 and 1985, and of the Insolvency Acts 1985 and 1986. More directors are being sued by dissatisfied shareholders, especially if they believe that directors' performance has contributed to their firms being targeted for acquisition (Kesner and Johnson, 1990).

Singapore is gradually moving from a regulatory system of corporate governance enshrined in statutes, to a more market-driven system where the aim is to achieve greater transparency and let the market itself decide on the quality of corporate governance based on the information available. In May 1998, the Stock Exchange of Singapore removed the mandatory Chapter 9B dealing mainly with the role and duties of the audit committee from its Listing Manual, and adopted a Best Practices Guide and the requirement that statements of compliance with this guide must be issued in companies' annual reports after 30 December 1998 (Singh, 1999). The Singapore system of corporate governance, however, was judged to be less well-developed compared to those of the UK and USA (Phan and Mak, 1998), especially in terms of disclosure to shareholders (Goodwin and Seow, 1998).

Boards have the normative tasks of monitoring and disciplining top management, being involved in such issues as executive succession, executive compensation and take-over defences, as well as being actively involved in strategy formation, on issues such as diversification, resource management and strategic change (Finkelstein and Hambrick, 1996). Empirical data from the UK (Dulewicz, MacMillan and Herbert, 1995) indicates that directors themselves take their strategic responsibilities seriously, believing that their tasks should involve the formation of vision, mission and values, direction of the company's strategy and structure, delegating to management and maintaining appropriate relationships with shareholders and other interested parties.

Descriptive studies have shown, however, that boards' actual performance does not usually live up to this normative view, and that shareholders are dissatisfied with several aspects of governance. Boards in general are not actively involved in strategy formation but at best in its ratification, and often avoid "rocking the boat" (Patton and Baker, 1987). Most often, there is insufficient training carried out for both executive and

non-executive directors specifically for their role as directors (Mileham, 1995). If CEOs' contracts are terminated as a result of a takeover or merger, in addition, they often receive exhorbitant severance payments, leading to substantial adverse publicity (Dalton, Daily and Kesner, 1993).

Director and board evaluation, moreover, is rarely if ever carried out, and often there are no systematic processes for identifying and selecting suitable candidates to serve as directors, but instead reliance on the personal networks of the chairman, CEO or other directors (O'Neal and Thomas, 1996). The relative power of CEOs and boards, in this regard, has been shown to influence whether a new director will be more demographically similar to the outgoing CEO or to the board itself (Zajac and Westphal, 1996).

Can Boards Add Value? The 10 Per Cent to 100 Per Cent Paradox

It has been argued that it is not the proper role of the board to formulate strategy, to overturn management decisions or to interfere in the decision processes of business units. This view is based on the "10 per cent versus 100 per cent paradox", questioning why board members who spend 10 per cent or less of their time in a company should be able to take better decisions than managers who spend 100 per cent of their time in that company. Managers who spend all of their time in the organisation, in this view, are far more knowledgeable about the company and its context than the directors who spend 10 per cent of their time in the organisation, and it is the managers who should make all tough decisions. It has been suggested, thus, that the proper role of the board lies within a limited sphere of ensuring that a clear and convincing corporate strategy exists, determining whether the senior management of the company deserves continuing support, providing specialist advice and acting as a sounding board for important decisions (Goold, 1996).

It is true that there are informational and temporal limitations on what the board can realistically achieve. There are also structural limitations, such as board size and diversity, which can suppress the board's ability to initiate strategic change (Goodstein, Gautam and Boeker, 1994). The 10 per cent to 100 per cent paradox should not be accepted uncritically, however. For example, if this paradox is valid, then consultants and organisation developers would by definition not be very useful, since they do not normally spend any significant proportion of their time in the companies they advise. Even though some consulting engagements leave much to be desired, others do

add considerable value. Why do consultants command an extremely high premium for their time? It is because firstly, they can bring advanced, best practice methodologies and processes into the client organisation, secondly, they can do so with a certain degree of objectivity since they are not enculturated in the ways of that organisation or involved in its politics, and thirdly, they can draw from their experiences in a wide variety of contexts and organisations to give appropriate advice to their client organisations.

The same argument applies by analogy to directors, particularly non-executives who are independent of any business or other linkages with the organisation (excluding cases where they are members of a controlling family or former company executives). Non-executive directors' detachment does impose certain informational and time limitations on what they can pragmatically be expected to achieve, but it also brings the advantages of a more objective view, having no vested interest in particular decisions; other than perhaps to increase the value of their stock options, if they are compensated in this way. This vested interest is tied to overall company performance, however, aligning the directors' and the company's interests.

Directors' experience in other organisations and contexts, moreover, may enable them to take a more holistic, "helicopter" view of the issues than managers who spend most of their time on daily fire-fighting. Whereas managers' tasks are more "hands-on", directors' tasks are more "brain-on", and involve different skills and competencies (Garratt, 1996). Through interaction and debate, competent non-executive directors can encourage executive directors who may habitually utilise "hands-on" skills and think within the established organisational paradigm (Johnson, 1987), to start developing "brain-on" skills and to challenge the established paradigm.

The strictness and forthrightness of the law with regard to directors' duties may thus reflect such high expectations by stakeholders of the value that directors can add to organisational performance, as well as the potential diminution of value by ineffective boards. The rising trend of shareholder suits (Kesner and Johnson, 1990), and their intensifying efforts to make directors more independent from management and more accountable to shareholders (Useem et al, 1993) reflect shareholders' own high expectations of boards' potential contribution to company performance.

Even with time limitations, boards can thus still make a critical contribution in long-term policy formulation, strategic thinking and planning, as well as supervising management and being accountable to the various stakeholder groups (Garratt, 1996; Johnson, Hoskisson, and Hitt, 1993). Looking at some more specific instances, boards could clearly add value, for example, by ensuring that when organisational performance is

unsatisfactory, senior managers do not become scapegoats whereas a powerful CEO remains in place (Boeker, 1992), or by consciously trying to reduce gender-based biases in board operations (Bilimoria and Kristin, 1994).

Frameworks exist that can aid boards address their vital functions, by allocating their time in a thoughtful and focused manner (Garratt, 1996), or improving the board's functioning and effectiveness as a whole through comprehensive audits or restructuring (Belcourt and Kluge, 1999; Donaldson, 1995, Firstenberg and Malkiel, 1994). Codes of best practice aiming to improve board performance have also recently been developed in several countries, with the UK taking the lead with the 1992 publication of the Cadbury Committee's Code of Best Practice (Cadbury Report, 1992).

What is Good Corporate Governance, and Does it Matter?

Good corporate governance can be defined as direction-giving by the board that fulfills the dynamic functions of board performance and board conformance, and leads to improved organisational effectiveness and efficiency, while taking into consideration the interests of relevant stakeholders (Garratt, 1996). The Cadbury Code of Best Practice published in December 1992 was a landmark document in corporate governance, aiming to distill best practices in governance from the most successful UK firms. Its central recommendation was that firms issue a statement of compliance with the code, which would be made a condition of initial and continued listing by the London Stock Exchange. Key points in the Cadbury Code were:

1. There should be a balance of power and authority at the top, by dividing the roles of CEO and Chairman. If these two roles are combined, it is essential that there is a strong independent element on the board.
2. Directors can seek professional advice if necessary, paid for by the company.
3. The board should include non-executive directors "of sufficient calibre and number" so that their views can influence board decisions.
4. The majority of non-executive directors should be independent of management and should be appointed for specified terms and be selected through a formal process.
5. Directors' total emoluments should be disclosed fully and clearly and their pay should be subject to a remuneration committee's recommendations.
6. Boards should establish an audit committee composed of at least three non-executive directors, which should report on the effectiveness of

the company's system of internal controls and that the business is a going concern.

Subsequent yardsticks of the effectiveness of corporate governance in several countries have largely been based on the Cadbury Committee's code, although additional measures have progressively been added. The most recent UK code is the "Combined Code of Best Practice" developed by the Hampel Committee, which has aimed to combine the recommendations of the Cadbury Committee with the later Greenbury and Hampel Committees. An extract of key points from this code is included in Appendix A.

Do such measures make a difference to performance? Unfortunately, we do not have a sufficient number of studies with unequivocal results, and we do need information on actual board functioning, processes and behaviours to form sufficiently informed judgements on this issue (Heracleous, 1999b). Research on directors' effects on performance has been extensive, focusing on such aspects as board size, outside director representation, director equity, director background and experiences, CEO duality (where the CEO also occupies the board chair role), board involvement in strategy making, board power, and other board attributes (Finkelstein and Hambrick, 1996). This research has produced mixed results, however, due to methodological and conceptual issues such as ignoring other contextual factors and their effects on boards and company performance, insufficient attention to group dynamics, the high complexity of the processes involved which cannot be captured adequately by statistical models, variations in how board attributes are measured across studies, and the use of different measures of performance.

For example, the key recommendation in codes of best practice that a separation between the chair and CEO position is associated with more independent boards has been questioned (Daily and Dalton, 1997). Different theories can have conflicting implications; for example, organisation theory views CEO duality as fostering strong leadership, whereas according to agency theory, CEO duality reduces the monitoring effectiveness of the board (Finkelstein and D'Aveni, 1994). The greater presence of outsiders (non-executive directors), moreover, is associated with higher company performance, but so is the greater presence of insiders (Wagner, Stimpert and Fubara, 1998). Common assumptions such as that CEO and board ties are detrimental to board effectiveness were shown to be inaccurate; such ties can promote more collaborative strategic decision-making without reducing effective board control or vigilance (Westphal, 1999). Results such as these mean that we cannot confidently make the assumption that a given "best practice" is best in all contexts.

There are some positive indications, however. Anecdotal evidence points to the fact that companies employing best practices in corporate governance may perform better than those that do not (*Business Week*, 1997). Investors are actually willing to pay an average of 11 per cent premium for companies they perceive as having good corporate governance (Felton, Hudnut and van Heeckeren 1996; Hawkins, 1997). The California Public Employees Retirement System (Calpers) reported that the 42 companies they targeted for improvement in corporate governance practices outperformed the Standard & Poor's 500 Stock Index by 52.5 per cent in the five-year period following Calpers' involvement (1987 to 1992), whereas these same companies had trailed the index by 66 per cent during the five years before Calpers' involvement (Crangle, 1998).

Does Singapore Need a Code of Best Practices in Corporate Governance?

There are potent arguments on both sides of the debate. Those arguing for not introducing a code of best practice in Singapore can point to the high ethical standards already upheld by Singapore corporations. They can also point to already existing controls on corporate behaviour as encoded in documents such as the Companies Act, or the SES Best Practices Guide and Listing Manual, as well as the state influence on many corporations' policies through appointment of senior civil servants on the boards of government-linked corporations, and through cross-directorships of key directors on several corporate boards. Lastly, opponents to the introduction of codes can argue that codes can impose cumbersome requirements on companies to comply, without any proven effects on performance.

Even though the above make a potent case, the case for introducing a code of best practices in corporate governance in Singapore is in our view much stronger, and will grow in importance in time to come. There are three main reasons for which introduction of such a code would be beneficial for Singaporean corporations and the economy as a whole.

Firstly, global investors will increasingly be using the existence of codes of best practice as one important yardstick to judge the quality of corporate governance in a country, and how serious is that country about improving its corporate governance practices. The global interconnectedness of capital and commerce mean that any single country cannot plausibly choose to isolate itself from global markets and trends without suffering severe economic and social consequences (as the case of North Korea demonstrates).

Secondly, a code of best practice in corporate governance would contain

clear guidelines for directors as to what the best practices are and what they should do to attain them. Current practices can thus be improved, in areas such as director selection and evaluation, which are often inadequate (O'Neal and Thomas, 1996). In Singapore in particular, the current limited disclosure practices to shareholders (Goodwin and Seow, 1998) would be improved by clear guidelines of what should be disclosed regarding board structure and organisation, and by making the statement of compliance a requirement for initial and continued listing on the SES.

Lastly, codes of best practice grant benefits that legislation cannot. They are flexible, since they can be altered much faster than legislation to respond to changing conditions. They are also more user-friendly than legislation, in the sense that directors can read and understand codes such as the recent UK combined code in just a few minutes, but would require a lot of time, strong motivation, and specialist knowledge to read and understand a Companies Act, for example. In addition, as soon as a code is made legally binding, individuals may start focusing on complying with the letter as opposed to the spirit of the law. On the other hand, codes of best practice can be more ambiguous than legislation, but this is a small price to pay relative to their potential benefits.

The potential impact of codes can be seen in the Cadbury Code's substantial influence in corporate governance practices in the UK (Conyon and Mallin, 1997; Samuels, Greenfield, and Piper, 1996). The Cadbury Committee's review of compliance found substantial improvements in such aspects as the separation of power and authority at the top, the existence of a stronger independent element on the board, the formation of audit, nomination and remuneration committees, the time limitations to directors' tenure, and the extent of disclosure to shareholders (Committee on the financial aspects of corporate governance, 1995).

Conclusion

Codes of practice can be controversial. For example, current debates with regards to such codes in corporate governance revolve around whether they should include considerations of stakeholders, as opposed to merely shareholders, and if so, to what extent; whether they should have more teeth to discipline non-compliant companies; and how far they go in terms of their recommendations. These are balances that need to be struck bearing the local context in mind. No code can escape critiques and controversy, as illustrated by substantial critiques of the Cadbury Code (for example, Boyd, 1996; Finch, 1992).

Codes, in addition, cannot be developed and implemented in a swift manner; a long period of evolution and maturity is required. The Cadbury draft code, for example, was issued in May 1992 about a year after the committee was formed following several consultations with interested parties, and the final code together with the associated report was issued in December 1992. Controversy about the "going concern" disclosure requirements in the original code led to a further period of evolution, culminating with the issue of guidelines devoted to this topic in November 1994; and finally, a review of compliance with the code was published in May 1995 (Committee on the financial aspects of corporate governance, 1995).

The corporate governance area in the UK has kept evolving, with the formation of the Greenbury committee to make recommendations on directors' remuneration, and the Hampel committee to review the Cadbury code and issue a further code that would integrate the Cadbury, Greenbury and Hampel recommendations.

For codes to have an impact, they need strong backing. For example, it is unlikely that the Cadbury code would have had such an impact had the London Stock Exchange not made compliance statements a condition for initial and continued listing. In addition, they have to be clear and brief, have practical guidelines, and communicated widely.

It is important to note, lastly, that codes of best practice are not a panacea. They form part of a larger whole of institutional arrangements, laws, company and industry codes of ethics, and most importantly, personal morality (Cadbury, 1998). But they do have an important part to play in improving practice by making people aware of what the best practices are, and inducing them to follow those practices.

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APPENDIX A
Combined Code of Best Practice (UK)

Section 1 Companies

A. DIRECTORS

The Board:

1. Every listed company should be headed by an effective board which should lead and control the company.

Chairman and CEO:

2. There are two key tasks at the top of every public company — the running of the board and the executive responsibility for the running of the company's business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.

Board Balance:

3. The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision taking.

Supply of Information:

4. The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.

Appointment to the Board:

5. There should be a formal and transparent procedure for the appointment of new directors to the board.

Re-election:

6. All directors should be required to submit themselves for re-

election at regular intervals and at least every three years.

B. DIRECTORS' REMUNERATION

The Level and Make-up of Remuneration:

1. Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully, but companies should avoid paying more than is necessary for this purpose. A proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individuals' performance.

Procedure:

2. Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Disclosure:

3. The company's annual report should contain a statement of remuneration policy and details of remuneration of each director.

C. RELATIONS WITH SHAREHOLDERS

Dialogue with Institutional Shareholders:

1. Companies should be ready, where practicable, to enter into a dialogue with institutional shareholders based on the mutual understanding of objectives.

Constructive Use of the AGM:

2. Boards should use the AGM to communicate with private investors and encourage their participation.

D. ACCOUNTABILITY AND AUDIT

Financial Reporting:

1. The board should present a balanced and understandable assessment of the company's position and prospects.

Internal Control:

2. The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

Audit Committee and Auditors:

3. The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Section 2 Institutional Investors

E. INSTITUTIONAL INVESTORS

Shareholder Voting:

1. Institutional shareholders have a responsibility to make considered use of their votes.

Dialogue with Companies:

2. Institutional shareholders should be ready, where practicable, to enter into a dialogue with companies based in the mutual understanding of objectives.

Evaluation of Governance Disclosures:

3. When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention.

Source: Hampel Committee