CAD-02287

COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

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22 November 1994

John Holland
Department of Accounting and Finance
University of Glasgow
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Dear Mr Holland

Paul Cahill of the DTI wrote to you on 18 November and advised that he had passed a copy of your research paper on corporate governance to me.

I think that the paper will be of great interest to both Sir Adrian Cadbury and other Committee members, and would seek your formal permission to circulate it to them for their consideration. It is the first study I have seen that has investigated the 'behind the scenes' role which the financial institutions are playing in the development of corporate governance in listed companies.

The full Cadbury Committee is meeting again on 7 December and if I could hear from you before then, it is possible that your paper could be discussed at that meeting when I would propose that it is added to the body of evidence which we are preparing to hand to our successor body, who will be reviewing the implementation and impact of the Code.

I look forward to hearing from you.

Yours Sincerely
Gina Cole.

Gina Cole
Secretary to the Committee

Department of Trade and Industry

10-18 Victoria Street
London SW1H 0NN

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Mr John Holland
Department of Accounting and Finance
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Direct line
Our ref 071 215 3232
Your ref
Date 18 November 1994

Dear Mr Holland,

Your letter of 7 October to the President of the Board of Trade enclosing a paper "Self Regulation and the Financial Aspects of Corporate Governance" has been sent to me for consideration.

Your research contains valuable insights into the operation of the relationship between financial institutions and companies. I and my colleagues would be very interested to discuss this further with you if you happen to be in London for any reason - I am afraid, however, that we have no funds to meet travel and accommodation expenses.

I am sending a copy of your letter and paper to Gina Cole, Secretary of the Cadbury Committee, who will also be interested in it.

Yours sincerely

P D Cahill
Companies Division

DPP-888

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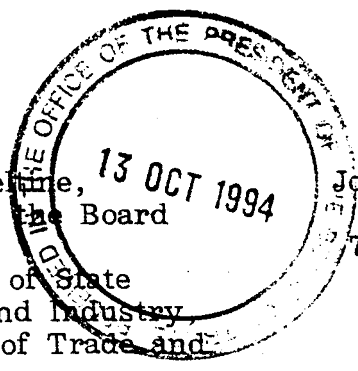
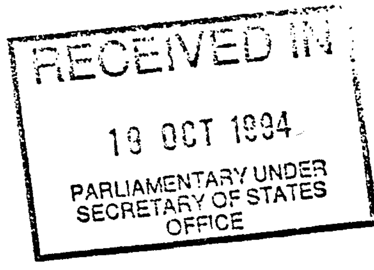
UNIVERSITY of GLASGOW



Mic. ael Heseltine,
President of the Board
of Trade,
& Secretary of State
for Trade and Industry,
Department of Trade and
Industry,
Ashdown House,
123 Victoria Street,
London, SW1E 6RB.

John Holland BSc, MBA, Phd

7th October,



Dear Mr Heseltine,

Thank you for the copy of your speech to fund managers at the September 23rd conference organised by Chemical Bank. One key part of your speech coincides with my current research project on the corporate governance role of institutional shareholders. During the period August 1993 to May 1994, I conducted field research by interviewing 27 large UK companies and 27 financial institutions.

One of the first papers to be written using the case material looks at the subject of 'Self regulation and the corporate governance'. This investigates 'self regulation' at the micro level of individual companies and financial institutions and argues that there still is a role for self regulation. I enclose a copy of the first draft of this report.

I have also used the case data to write papers on
'The corporate governance role of financial institutions'
'Corporate problems with the identification and dissemination of price sensitive information.'
'Self regulation and the dissemination of price sensitive information'

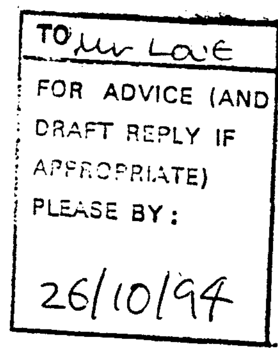
The research is clearly very topical and up-to-date. I would be very interested in your comments or those of your senior advisers on these matters.

If you would like me to dicuss to discuss the paper with you or your staff, I would be glad to visit the DTI. I have run out of research funds and I presume that the DTI would be happy pick up my travel and accommodation expenses. We could also possibly use the occasion to discuss the issues arising in the other three papers.

As an alternative, you or staff could write some critical comments on the paper and send them to me. We could then have a discussion on the phone.

I hope you find the paper of interest and I look forward to hearing your views.

Yours Sincerely,
John Holland,
Senior Lecturer.



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SELF REGULATION and THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

John Holland, University of Glasgow, October 4th, 1994

1 Introduction:

The problems of Mirror Group, Polly Peck, and others, and the ensuing confrontation between suppliers of capital and the company board and management, have been the stimulus to rethinking the UK approach to corporate governance. As a result guidelines have been published by the Cadbury Committee (London, December 1992) concerning 'Financial aspects of Corporate Governance'.

This paper is concerned with 'Behind the scenes' self regulation by companies and FIs relative to the corporate governance guidelines outlined in the Cadbury Report. The paper investigates a private form of self regulation outside of the more public form of self regulation overseen by professional bodies and the SIB. The focal point for this private self regulation process is the close co-operative relationship between a financial institution and an investee company. These relationships are employed as a common base around which to illustrate self regulatory processes at the level of individual financial institutions and companies. The paper ends by investigating new directions for research and for regulation.

2. Research methods:

This research sets out to explore the following question. How do the close co-operative relationships between financial institutions and their investee companies play a role in ensuring compliance with externally defined standards in the field of corporate governance ? The case study method was adopted to investigate this question because of the limited prior work at this micro level and because this research method allows rich insight into new research fields (for example see Scapens 1990, Hopwood 1983,).In the period June 1993 to March 1994 executives in 27 large UK financial institutions (FIs), and 27 large (22 FTSE100, 5 in FTSE 100 to 200) UK companies, were interviewed. The case FIs constituted 27 out of the thirty five largest UK FIs (by own and other funds managed) and included Life Insurance, Pension Fund, Unit trust and Investment trust FIs. The company and institutional participants were asked to discuss their links or relationships and to explain their role in corporate governance. The cases are used in the article in four ways. Firstly, as the basis for developing concepts of relations. Secondly, the cases illustrate how the financial institutions and companies were using their close links as a mechanism for self regulation in the area of 'Corporate Governance' . These relations reveal that 'Self regulation' was interpreted as two way control exercised through an extensive network of voluntary or implicit relationship contracts between financial institutions and companies. Thirdly, the cases are used to provide short cases and quotes to enliven and illustrate these concepts. FI case studies are used to demonstrate how FIs can control and influence the CG behaviour of their investee companies towards 'good practice'. Corporate cases are used to explore how companies sought to stay within the Cadbury guidelines and how they responded to, and interpreted FI pressures on this issue. The costs and benefits faced by FIs and companies as self regulators are also discussed. The paper therefore reveals part of a hidden or 'behind the scenes' self regulatory mechanism and provides some clues as to the conditions under which this mechanism might function. Finally, the case data is used to explore the connections between the legal, self regulatory and social control mechanisms.

The patterns of relations concepts and self regulation methods identified from the cases are limited in that generalisations should be restricted to the cases studied. Acquiring this degree of access to key decision makers in FIs is unusual in research in the fields of regulation and corporate governance. This unique access has provided the data for an illuminating study how this self regulatory process is conducted and has also provided the means to look at self regulation from a novel 'bottom up' perspective.

3. Self regulation and Corporate Governance:

Corporate governance is a broad and somewhat vague term for a range of corporate controls and accountability mechanisms designed to meet the aims of corporate stakeholders. Tricker (1993) defined the boundary to the field of study as 'Corporate Governance covers the concepts, theories and practices of boards and their directors, and the relationships between boards and shareholders, top management, regulators and auditors, and other stakeholders'. In the Cadbury report (December 1992) the stakeholders are primarily understood to be the shareholders of the firm. Even with this narrowing down on the 'financial aspects of corporate governance', there

some ambiguity about the term. Sir Adrian Cadbury's comments (Observer 6-12-92 p36) that 'Corporate governance is not a happy phrase' and that its meaning to most people will be a 'system to curb the excesses, and follies, of despotic company bosses'

Laws, self regulation rules and social controls form the basis of the UK system for corporate governance. The following table summarises the major elements of the UK system.

Corporate governance

LAW	Companies Act (1844-1985) for shareholder ownership rights, Duties of Board. Pension fund law & trustee duties. (Trustee Investments Act 1961), Fiduciary duties of Directors, EU directives on Company Law.
Regulated autonomy or formal self regulatory system.	ISC code 1991, Cadbury Report 1992. NAPF & ABI codes of conduct. NAPF survey of corporate compliance with Cadbury. ASB reporting pronouncements and OFR guidelines. Audit practice board.
'Behind the scenes' self regulation.	Individual FIs and groups of FIs act a main agent for Cadbury, NAPF, ABI to regulate corporate governance standards. FI and corporate use of their close links as primary 'behind the scenes' mechanism.
Social or 'club' control	Informal 'City' networks of FIs, analysts and fund managers, combine with corporate networks. Flexible exchange of information and formation of core FI influence groups.

The board is the legally defined corporate governance mechanism with other board mechanisms including, its independent non executive directors, AGMs, separate holders of CEO and Chairman offices, and independent audit, remuneration, and appointments sub committees (of the board). Company board corporate governance mechanisms are underpinned by a legal model of investor property rights arising from share ownership (various UK Companies Acts from 1844 to 1985). This incorporates,a clear chain of accountability from the management to the board and then onto the investors. The Companies Acts also define minimum disclosure requirements and require companies to conduct their affairs in accordance with Articles of Association as approved by shareholders from time to time. More specifically investors have the right to use a simple majority vote to remove any or all of the directors at any time and for any reason. The Stock Exchange imposes extensive listing requirements on applicant or currently quoted companies. The Takeover Panel has an extensive sets of rules for takeovers and the purchase of large shareholdings (Brown 1991).

Ganz (1987) refers to the exponential growth of 'quasi regulation' or ' a wide spectrum of rules whose only common factor is that they are not directly enforceable through criminal or civil proceedings'. This has taken many forms including codes of practice, guidance, guidelines, codes of conduct and many other guises in post war UK society. Puxty et al (1987) argue that the form of domestic regulation is an expression of the dominant models of social order adopted in each sovereign state and they consider the UK is principally 'Associationist' in terms of regulatory organisation. 'Associationism' is a strategy of (self) regulation where 'there is some dependence on principles of community. However, such principles are routinely subordinated to those of the Market. Membership is founded principally upon calculative rationality rather than a desire to share in common values'.

The Cadbury Report (1992) corporate governance guidelines and the professional body codes of conduct both fall under Ganz (1987) and the Puxty et al (1987) definitions. They constitute a form of regulation with more public

·rest authority than pure self regulation exercised by a community of professionals but weaker than the full ıω.ce of law. They consist of a form of 'Regulated autonomy' which is backed up by Company law, the FSA and other legislation (Birkinshaw et al 1990. This involves market and corporate based participants as rule developers and rule implementors operating within general principles outlined in law, the SIB, and by the Cadbury Committee.

In part, the Cadbury Report probably reflects the vested interests of the Accountancy professional bodies, the corporate sector, the Stock Exchange, and other market participants in a well established City influence process. Many of these groups lobbied hard in 1991 and 1992 to influence the Cadbury Report. Many of these groups were represented on the committee and helped produce the report. This City political process, indicates,in part, why the Cadbury Report reflects a negotiated balance between these vested interests. It also suggests why they seek to control the system for designing such control or guidance, and why they have not sought radical change in this system.

The Cadbury Report (1992) has identified the board level mechanisms as essential for ensuring high quality monitoring of the financial aspects of CG, especially for financial reporting and auditing issues. Given the recent corporate scandals the Cadbury Report sought to clarify this chain of accountability and to build monitoring and accountability into boardroom and managerial decision processes. The Cadbury committee adopted the self regulatory approach because they felt additional legislation would stifle innovation and enterprise. The Stock Exchange was influential in putting this view forward (Stiles and Taylor 1993). However, Sir Adrian Cadbury argued that, (p24, 1993) poor implementation of the Cadbury code may lead to UK government regulation.

A major thrust of Cadbury related to non executive directors or NEDs (Finch 1992 p591). They should bring an independent judgment to bear on issues of strategy, performance, resources, key appointments and standards of conduct. This implies that non executive directors (NEDs) are also expected to spend some time monitoring executive directors on the board on the behalf of shareholders. In addition, both executive and non executive directors are expected to improve their monitoring of non board top managers on behalf of the board and ultimately shareholders. Problems still remain with aspects of the UK CG system. The single tier nature of the UK board means that the supervision and monitoring roles can become entangled with the strategic decision making and management role of the board. In contrast, the two tier German board is designed to separate these roles. In addition, the NED, who with other members of the board, has the main responsibility for monitoring management, has the same legal duties as the executive directors. Legally they are part of a common team. However, if they are to discharge their special new roles, they may find themselves at odds with the executive directors. (Economist Jan 1994). Finch (1992 p 584), also points out that the imprecision of the NED recommendations undermines their force.

The Cadbury Report also called on institutional investors to play a more active role in securing better corporate governance (s6.16), to take a positive interest in the composition of board (s6.11), to make positive use of their voting rights (s6.11) and to disclose their policies on the use voting rights (s6.12). Cadbury drew on the Institutional Shareholders' Committee (ISC) own 1991 report on these matters and reinforced the ISC's recommendations. The Cadbury committee saw the development of constructive relationships between companies and their owners as central to this process. Institutional investors 'should encourage regular, systematic contact at senior executive level to exchange views and information on strategy, performance, board membership, and quality of management'(s6.11) and 'Because of the importance of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholder's Committee, to use their influence as owners to ensure that companies in which they have invested comply with the Code...... The obligation on companies to comply with the Code provides institutional and individual shareholders with a ready made agenda for their representations to boards. The committee is primarily looking to such market based regulation to turn its proposals into action' (s6.16)

The Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) have responded by encouraging their members to develop a voting policy and to exercise their proxy votes whenever possible. Since 1993, NAPF have provided their members with a 'Voting issues service', which monitors the FTSE350 and prepares reports on corporate resolutions requiring shareholder approval. They also give members checklists of each company's performance against major corporate governance standards and provide support to members by highlighting resolutions viewed as contentious, by providing advice to members on voting issues, by providing duplicate proxy cards, and background notes on corporate governance issues. Companies liaise with both NAPF

' ABI and these bodies encourage good corporate governance practice with them.

Sir Adrian Cadbury (p19, 1993) explains his view of the role of large financial institutional shareholders as follows, 'It can only be the large institutions which have that direct line into boards, but the question is how are they going to use that ability to open up a dialogue with a board? I would suggest that what we have done (in the Cadbury Report) is to set a series of principles of good practice which they can discuss with the board to see whether they are following them and in which way they are following them. This avoids the problem of insider dealing. It is not that they will be going to the board in order to find out whether next month's trading looks good or not. Their interest in better governance'

In the case of corporate compliance,
'The question as to whether boards will listen to shareholders turns partially on what the shareholders have to say. and the way they say it, but in the end it turns on the reactions of the market. If you ask on what basis do we expect companies to comply with the recommendations we have put forward, I believe that companies will, on the whole, comply, because they will see it as their self interest to do so; because it will improve their standing in the market. Exactly, the same argument, therefore should apply to the shareholders in these companies. They will want to see their companies comply because it will be for their benefit as well. So I think it is the pressure of the market which will bring companies into line with the standards which we believe should be adopted.'

The stock market thus acts as an another supporting mechanism for regulation or control in these areas (Axworthy 1988 p291). The 'market for corporate control' is a corporate governance mechanism that can be used by investors to pressurise management into compliance with Cadbury. In the form of the 'market for votes' it can help shareholders contest management and board proposals during AGMs and EGMs. The media act as continuous monitors and are also a significant force in encouraging compliance with Cadbury. However, this article focuses on the 'relationship' mechanism for corporate governance self regulation. The larger control system including markets, the law and the media is discussed in section 8.

4. Company-Financial Institution relations:

We can see from the Cadbury Report that the major onus is on FIs to ensure corporate compliance with the CG guidelines in the Cadbury report, with companies under considerable pressure to respond to these guidelines. This highlights the role of FI-Co relationships as the point at which the CG self regulatory process is conducted.

Company-Financial Institution relations are one of the central links between shareholders and senior management and the board. They involve complex networks between companies and shareholders. In the UK and to a lesser extent in the US, large shareholding financial institutions and their fund managers dominate such direct links. The fund managers are normally located in large investing financial institutions (FI) such as Pension funds, Insurance companies, Unit and Investment trusts as well as major banks.

The case fund directors and managers operated in FIs that were all supplying some form of saving service for their clients. They all had a fiduciary duty to supply their clients with their preferred mix of return, diversification and liquidity (Pozen 1994). This requirement dominated the case FIs view of their interactions with their investee companies and underpinned the primary economic exchange between the parties. However, this primary exchange occurred in the context of a close, co-operative FI-Co relationship and this involved many other supporting exchanges, state changes and interactions.

More specifically, in the FI and company cases, a close, co-operative FI-Co relationship was characterised by
- a voluntary (primary) exchange of (new) capital for a proportional share of the company's future residual cash flows in the form of dividends and growth, and an exchange of stable FI stakeholding for access to high quality managerial talent and continued good corporate financial performance
- a voluntary exchange of supporting elements such as information, opportunity to learn, and influence - generally two way flows.
- desirable changes in state for both parties such as enhanced knowledge, reputation and confidence both in the FI and company.
- repeated interactions through which the secondary exchanges can take place and changes in states occur. These include 1:1 meetings, phone calls, conferences and other direct contacts.

ıs the case FI-Co relations involved information flows, influencing and interaction processes, as well as the ıᴜrmal structures of the links. FI-Co links revolved around co-operative stable relationships, which regular meetings and other channels for two way flows of information, and feedback mechanisms after meetings. A close working relationship based on honesty, integrity, stable stakeholding and regular contact was considered by the case FIs to be one of the most effective means by which their influence could be exercised. This influence in turn was used in the expectation that the FI could boost fund value by acquiring a deep understanding of the business and securing private information flows from the investee companies when required. It was also used to suggest changes in managerial decisions, and compliance with corporate governance guidelines.

The SE guidelines on price sensitive information and insider trading laws imposed a barrier to close relations between companies and FIs. As a result the case FIs did not seek price sensitive information in these meetings. They did seek to understand corporate strategy, to assess the quality of management and the coherence of the top management team, succession policy, and to collect information on the competition and the industry. They judged the quality of this information in two ways. Firstly by comparing management actions with their statements, and secondly by comparing company information with the sell side analysts, media, and their own research sources. All of this information was used in their valuation and stock selection decisions.

The case FIs differed in their core company holdings in the FTSE 350. However all of them had relatively stable stake holding policies for a large number of UK companies. The case FIs used these multiple corporate relationships to enhance their monitoring ability. These sources were enhanced by the each case FI, developing its own internal research and analysis function and using its own select group of external research analysts. All of these sources combined to give the case FI's unique insight into each investee company. This improved the FI's capability to assess corporate information and to ensure that the company remained accountable for its use of FI capital.

These relationships existed for the case companies with their core 10 to 20 FIs comprising from 15% to 50% cumulative stake in the company, with the relationship element strongest with those FIs with a stable stakeholding (with some trading) policy. The case companies employed these core FI relationships for City communication purposes, to stabilise financing sources and to gain FI and analysts support during takeover battles. They were acutely aware of the desire of FIs to use these channels to gain new information. As a result these were the primary channels through which the case companies sought to negotiate with FIs, to control information releases and to avoid private releases of price sensitive information. The use of multiple relationships by both the case FIs and companies suggest that the ideas of 'investor relations' and 'relationship investing' were pervasive across a large sector of UK industry and investment houses.

The case data concentrates on large public companies and large FIs. There may be many other factors effecting the character of FI-Co links in the case of smaller companies and FIs, and with private companies. An assumption of this research is that the unravelling of large FI - large company links and their role in regulating CG, will provide a benchmark for understanding other interactions as well as illustrating a major source of influence on other FI-Co CG interactions involving smaller companies and private companies.

5. FI use of close company links in the self regulation of corporate governance :

In sections 1 and 2 we have seen that a series of corporate frauds and problems led to a rethink of corporate governance in the UK. This led to the Cadbury Report and a debate throughout 1991 to 1994 concerning the role of FIs in encouraging 'good' corporate governance in large UK companies. The case FIs responded to this new self regulatory climate in a variety of ways with their response effected by factors such their power relative to the company, the costs and benefits of the lead regulator role, and the range of influence and intervention choices open to them. Ultimately, their behaviour was driven by fund performance considerations.

In section 5.1, the FI case data is used to illustrate general patterns of how the case FIs tried to encourage their investee companies to comply with Cadbury and to accept self regulation as the best way forward. In section 5.2 two cases are use to illustrate how the FIs tried to exercise this influence both as individual FIs, and as part of a groups of FIs. The cases also show how the FIs used a combination of advice, influence, league tables on compliance with Cadbury, and in some cases direct intervention to ensure that companies complied with the new code of conduct for CG. In section 5.3 we consider the influence of clients or customers of FIs on FI self regulation of corporate governance. In section 5.4, FI power and sanctions in the lead self regulatory role is

estigated. In section 5.1, the case FIs views of their cost and benefits when acting as the lead self regulator are explored. Sections 5.1 to 5.5 therefore provide a detailed insight into the lead self regulatory role of the case FIs.

5.1 Case data on FI use of close company links to ensure corporate compliance with corporate governance codes of conduct :

The following diagram illustrates the broad thrust of FI intervention on CG issues identified in the cases.

```
COMPANY                                                  FINANCIAL
---------    <====<=====                               -------------
        |   Use of close corporate links to            | INSTITUTION |     FI
        |   precondition and influence companies       |             |     Share
        |    BEFORE they make decisions on,            |  FI         |     trades &
        |    remuneration,perks, options,              |Investing    |     signals to
        |    duration of rolling contracts,   <=====   |  policy ===>|     Stock
        |    succession policy, and                    |             |     market &
        |    'reward for failure'             <=====   | Cadbury     |      =========>
        | <===                                         | code & FI's |     FI Signals to
        |                                              | corporate   |     its Investment
        | <== Plus advice on financial performance     | governance  |     management fund
        |     before its goes wrong.                   | standards   |     clients about
        |                                              |             |     CG Policy
        | <== Plus private letter to investee     <=== FI power to |
        |     companies on CG standards expected by FI  | influence   |
        |                                              | companies & |
        | <== Plus the use of NAPF survey of Cadbury CG | costs/benefits
        |     compliance to pressurise change in companies | of FI influence
        |      Thus check company compliance on        --------------
        |       -separation of Chief executive & Chairman roles
        |       -adequate number of non executive directors
        |       -existence of independent committees
        |
        | <== Plus collective action by a group of FIs.
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```

This influence and intervention was normally conducted through co-operative FI-Co relationships. The case FIs made extensive use of their close corporate links to precondition and influence companies before they made decisions on remuneration, perks, duration of contracts, succession, and to prevent companies offering some executives a 'reward for failure'. They also used new corporate proposals as an opportunity to raise CG compliance issues and to probe how changes in succession, pay schemes, and contract structure, were going to play a role in improved corporate financial performance. Cases 1 and 2 below provide examples of how this process was conducted. Company relationships were used to provide advice on corporate financial performance before it went wrong and FIs also issued private letters to investee companies on CG standards expected by the FI

Pension Fund FIs made extensive use of the National Association of Pension Fund (NAPF) survey on Cadbury compliance to pressurise change in companies. They used this survey to check company compliance with the recommendation to separate Chief executive & Chairman roles, to establish non executive directors, and to make use of independent committees. Professional body subcommittees such as ABI and NAPF investment committees were used by FIs and companies as 'sounding boards' for new proposals such a novel financing methods which changed ownership rights. These situations were unusual but were a flexible means of establishing general CG standards for new, evolving circumstances. Case 1 below provides an illustration of this process.

Much of this process of influence and intervention process was conducted by the case FIs outside of the public gaze. The reasons for this were complex and those identified in the cases included, the UK law of libel and slander, a UK culture of secrecy and politeness, the speed and efficiency of the process, the 'clubby' nature of

City, and a preference on all parties for this private process rather than public disputes which could damage reputations of all concerned. Case 2 below provides a typical case view of the reasons for going 'behind the scenes'.

The disputes and conflicts in this private influence and intervention process rarely break out in the public domain. Some recent public examples of FI pressure on companies include Saatchi and Saatchi (1994), Pentos (1993), Amstrad (1992), Pegasus (1992), Hanson (1992), and Lonhro (1992). For example, in April 1993, Ross Goobey at Postel publicly wrote to the chairmen of the top 100 UK companies informing them that Postel expected its investee companies to get rid of long term rolling contracts which can lead to poor performing managers receiving large pay offs. Despite the slow change here in UK boardrooms he says 'We haven't stopped talking to people about the subject of rolling contracts and remuneration packages'. He argues that much is going on behind the scenes concerning these and other corporate governance issues. 'There is a point when going public can be useful. But those occasions are very rare... It doesn't mean nothing's been happening'. In terms of going public on some of these issues he says 'There is a point when, if the company tells you its none of your business, you have to gather support for your view amongst other shareholders, and ultimately you may have to go public on it. The media can be useful in getting a point of view across to other shareholders, maybe small shareholders and institutions who may not be aware of what is happening, and getting a groundswell of opinion to put more pressure on management'. He points out his role in Amstrad's and Alan Sugar's failed buyout offer for Amstrad 'Going public on that did, I think, alert some of the small shareholders'. Similarly, with his intervention in Pegasus the accounting software company, where he helped to engineer a boardroom coup. (All reported by Patrick Hosking in the Independent on Sunday 30 Jan 1994 p 8)

Despite the lack of public visibility of this influence and intervention process, the case FIs were prepared to discuss how this 'behind the scenes' process was conducted. The following two FI cases are employed to illustrate how this influence and intervention process was conducted by the case FIs. In case 1 we see how FI professional bodies played a central role in encouraging compliance with Cadbury. Case 2 provides illustration of why FIs preferred to 'go behind the scenes'. Both cases 1 and 2 also illustrate examples of failure of relationship and professional body 'behind the scenes' influence processes. The case FIs recognised the limits of this approach and emphasised the benefits of a using combination of influence and disciplinary approaches.

5.2 FI Case 1 - Individual and collective FI 'Behind the scenes' influence on companies:

'In our regular 1:1 meetings with our portfolio companies, the NAPF corporate governance checklist, the corporate governance aide memoire, and the company voting issues report are all very useful pressure points. These meetings occur between the company and institution after the report announcements. If the institution fund manager (FM) has the reports on their desk during the meeting then they can provide support to many FM arguments when dealing with the company management. They are backed up by Cadbury, by NAPF guidelines, and by the relative compliance of the company compared with similar companies. This exerts further pressure on the company to comply. If a company complies very little there is intense pressure to conform. If it is complying slowly but surely then we can accept their pace of change as long as their financial performance is OK. If not, then we can put further pressure on them to conform at a faster rate.'

'A company may propose a new remuneration package for executives based on say an option scheme. We will respond by saying OK but what about the flow back or added value for us as a result of implementing this scheme. We would like to know how this scheme would produce improved corporate financial performance relative to some kind of sensible benchmark such as the sector's performance. Their proposal allows us to begin a dialogue with the corporate executives which we can use to pressure them to move towards financial performance aims consistent with the needs of the company and our needs. We are not too concerned about the specific form of the remunerations scheme or the size of the benefits potentially coming to management as long as we have reasonable expectations that the scheme will create the climate for better than benchmark performance, we get a share of the additional benefits, and the company is creating enough internal capital for further investment and R&D. If the proposal improves the company's competitive edge and enhances stock market values and the extra 'cake' is shared out sensibly then we are all winners. We do not agree to remuneration contracts that contain rollover clauses for management that mean expensive compensation for managers having to depart for poor performance.'

'The professional bodies such as NAPF and ABI work together to prepare guidelines on any matter that we think

ects share prices and thus effect fund performance. In the case of remuneration contracts, we do not have specific prescriptions. We do however have clear guidelines on the independence of remuneration committees. We also seek full disclosure of remuneration schemes. This information means we can ask remuneration committees sensible questions. In this way we can see a clearer link between a CG mechanism, remuneration and financial performance.'

'There is lot of 'behind the scenes' or 'paddling under water' involved in influencing companies. Management may approach their large shareholders and say we would like to do this. Alternatively, the large FIs such as Postel or CIN may approach the company or the investment committees of ABI and or NAPF on some matter.

If a FI approaches NAPF's investment committee on some matter and asks what do they think of a company's proposals or behaviour, then the committee will take soundings amongst major equity holders and bondholders. The committee will try to see their response to any action proposed and see how it fits with NAPF guidelines. NAPF will probably also confer with ABI if major FI investors in the company are Insurance companies. Sometimes there is concentration of PFs or Insurance Companies in the company stakeholding and one body acting as co-ordinator will suffice. If both types of institution are involved then a joint effort is desirable. A quick phone call between the bodies can be sufficient.'

'One of the major advantages of the City is that there a small number of professional FI bodies and they are all nearby and in close contact with each other. We think US PFs and insurance companies are more fragmented both professionally and physically in the US financial system and this hinders co-ordination.'

'If a big issue is involved then NAPF will form a 'Case Committee' to focus on the issue alone. This will normally consist of the major PFs with a chairman from the Investment Committee of NAPF. This case committee then goes into purdah as it goes through a series of confidential meetings with the company and within the committee. The aim of the committee is to try to get the situation resolved and to seek a satisfactory solution to the problem or issue from the perspective of NAPF, the company and its shareholders. This may all occur outside of the public gaze and never reach the public domain. If a public announcement is eventually required, the Investment Committee will make it and not the Case Committee. We only deal with 2 or 3 problems like this every year.'

'Recently, we had to deal with a problem at a major company. We, and several other major shareholders were concerned about the company's proposals at an extraordinary general meeting for an executive share option incentive scheme. The ten year scheme will allow executives to buy share options at current market prices and to exercise them after three years, providing the share price rises. The problem is that there is no minimum criteria on share price performance. Both NAPF and ABI recommended that executives should not be allowed to benefit from options unless the company has really improved its performance. The scheme will reward executives for general upward market movements and will not reward the individual efforts of high performing executives. The options should only be exercised if the company's share price outperforms its sector and the market as a whole. We told the company we will vote against the proposals and ABI and NAPF have made objections. We tried to work behind the scenes with the chairman to develop an incentive scheme consistent with shareholder's aims. Unfortunately, the chairman was not interested in our proposals. A large private shareholder supported him and senior executives own enough shares to stop us forming a majority. We therefore could not change the option scheme. This is unfortunate because the problem is already high profile. The company seems to have recognised this because changes have been made on the remuneration committee following on closely from these events. Perhaps the corporate sector will get the message.'

<u>5.2 FI Case 2 - Corporate governance, close FI-CO links and reasons for 'going behind the scenes:</u>

'We have our corporate governance staff who will identify the four or five CG issues arising with a company. The company knows before the meeting that we have someone specialising in CG and therefore comes prepared to answer questions on this area. They also know our general position on many CG issues. In these ways we influence them to change their CG stance before they discuss the matter with us in meetings

'Most companies think that Cadbury is a 'good thing' and a step in the right direction, but they recognise that it will not stop the crooks out there from trying to beat this new system. Companies will comply with Cadbury as long as it is not too onerous or has a significant negative impact on their performance.'

'ose FI-Co links are one practical way in which we and other FIs can help cajole and push companies towards the kind of CG standards implied in Cadbury, without having to impose the whole formal set of mechanisms and board sub committees proposed by Cadbury'

'We do not wish to impose too many costs on companies by asking the top 100 UK companies to comply fully with Cadbury so that some of them find that it interferes with their financial performance. Financial performance must remain number one for us'.

'The Maxwell case was important for me. I learnt quite a lot during this matter. The UK is a very polite society with an inability to bring things out in the open. We avoid having fights and tend not to go public and not to make accusations about the behaviour of managers. Before the Maxwell case, journalists were always phoning up and asking for information and quotes about Maxwell. We did not make comments because we knew Maxwell would sue. We guessed that he was up to no good and so we sold all of our shares long before the problems came out. This case has given the City a bad name and stimulated all the recent actions on Cadbury. I wonder whether we did the right thing by not saying anything'

'Things like this are still going on and the City and press rumour mills are providing plenty of information on not too dissimilar cases. The problems are our culture of 'not rocking the boat' and 'trying to be respectable' prevents us from opening our mouths and the laws of libel make sure that they stay shut. The cultural and legal factors all drive the problems underground. This means that 'behind the scenes' influence through FI-Co links is probably the best way to get things changed and to move forward on corporate governance standards. We certainly prefer to change companies through these private channels outside of the public gaze'

'Barclays Bank is a good example of this. We and other FIs tried privately to encourage Barclays to separate the Chief Executive and Chairman roles. We first tried it behind the scenes and when we failed we went public, and worked with other FIs to put the pressure on. In the end the bank gave in.'

'A counter example to this is the chief executive who phoned up the top 6 FIs owning about 20% of his company and told them that the next day he was announcing that he was going to combine the chairman and chief executive roles. He picked us off one by one, before we could contact each other. I told him at the end of our phone call that we would oppose this proposal. However his charm and personality was such that the other five did not actually say no to him. Once he had established this, he knew that they would have difficulty backtracking later. I phoned up the others after he had spoken to them and found this to be the case. This example shows how important personality and individual relationships are and how important decisions can be made very quickly given these relationships.'

'A groups of FIs could reverse this managerial led process. Five or six of us who know each other well and have the most significant stakes in a company, could quickly come to a decision through a few quick phone calls. This could be about a corporate governance issues, a rights issue, or say a bid. If we can agree then this is powerful force that few management teams can ignore'

'If we intend to vote against a company motion at an AGM, we tell the company, the press and other financial institutions. Usually it does not come to this. The company either drops the motion or promises to alter the way it implements the proposal. We do not go to AGMs but we always vote or sometimes abstain. We never ignore a vote and make our opinions known on it by voting, abstaining, as well as a private word in their ear through a phone call to the chairman. We think it important that the company thinks that we are an important and active shareholder. A company will ignore us if we do not do this. In the case of two FIs with the same stake, but one votes and the other doesn't, the one that votes will have the greater influence'

'There are many problems in trying to get FIs together to co-ordinate their influence or actions against company management. For example, the one large FI prefers to be in lead of a group of FIs. We experienced this 'pecking order ' issue from this FI in a case in 1993. The FI is so big is does not like being told what to do by other FIs. There are weak links between some FIs because they have different vested interests such as each FI may have different fund performance outcomes arising from change or influences corporate behaviour. Their different stake levels may be the basic problem, but it could be that the company concerned is particularly important or unimportant in the context of each FIs portfolio. In general, anything which has differential effects on the fund management performance of FIs marks a dividing line for co-operation between FIs. They are competitors here

' are unlikely to offer another competitor a helping hand. Co-operation is more likely if the influence or intervention is low cost and involves an issue on which there is general agreement. Thus letters of advice to companies are low cost, and issues such as separation of chairman and chief executive roles commands broad support'

5.3 Clients or customers of FIs and their influence on FI self regulation of corporate governance:

The case fund directors and managers operated in FIs that were all supplying some mix of return, diversification and liquidity for their clients. This requirement varied across investment trusts, unit trusts, pension funds and life assurance institutions. The pension funds and life assurance institution placed greater emphasis on long term relationships with investee companies as means of satisfying their client needs for long term investments. In addition, those institutions with a large proportion of managed funds, especially corporate, union and industry pension funds, sought client approval for their corporate governance policy.

The role of these customers in influencing FI CG policy, in imposing constraints on, or in getting FI to reflect their narrow vested interests was not clear from the cases. For example it was not clear whether they supported maximising returns or would they like to support other issues (green issues, employee issues etc).

A small number of case institutions communicated their corporate governance policies to their fund clients. The aim was gain the support clients for these policies and to avoid reduced fund management business arising from misunderstandings here. FI Case 3 provides some insight how the financial institutions communicated their corporate governance policies to their investment management clients and how these clients influenced these policies.

> 'Last year (1993), we wrote to about 180 pension fund and other managed fund clients to explain our voting policy in company meetings, our readiness to co-operate with other institutions in the promotion of corporate governance, and our intention in formal and informal contacts with company management to encourage best corporate governance practice. Our corporate governance policy was based on the Cadbury report and the ISC's guidelines. We emphasised that the fund management contract with us meant that we would exercise our clients voting rights in pursuit of these policies. We asked for comments on this policy and sought their approval for it. About 80% (140) replied and most assented to the policy. The 20% that did not reply, probably ignored it because it was not an issue for them or because they did not have someone in their pension fund to respond to the letter. Two or three replies gave pragmatic, self interested reasons against part of the policy. The common factors in these three examples are 'Don't rock the boat', 'Don't offend or embarrass the 'great and good', and 'Corporate governance is fine in general, but not in specific cases that effect our interests'. These responses formed a very small minority (4%) of the total clients surveyed. The vast majority supported our policy.'

5.4 The self regulatory role and FI power and sanctions:

The potency of the self regulatory lead role of core FIs in corporate governance depended on the relative power of the case FIs and the circumstances surrounding the FI influence or intervention.

Three different type of situations were identified from the cases for the exercise FI influence.
1. Within existing co-operative relationships with investee companies.
2. At 'pressure points' during the co-operative relationships with investee companies.
3. When the investee companies face adverse circumstances.
FI power to influence the company increased as it moved from situation 1 through 2 to 3.

In the first case of a co-operative relationship, the FIs continuously exercised a positive influence on the investee companies before the company adopted new proposals, as well as when the company was employing specific corporate governance practices. The case FIs had considerable power to influence the company in this positive way. The FIs also had negative sanctions in that they could imply that poor compliance could threaten the fruitful FI-Co relationship and the company could lose the information, feedback, financing and takeover support advantages arising from the close relationship. This implied sanction could be magnified across all core FIs. The case companies had similar relationship sanctions.

The case data indicated that FI influence or exercise of power over corporate decisions (within this co-operative context) was a complex function of many associated factors such as,

e size of the stakeholding in the firm.
ıne size of the investment house. This influence declined with increasing size of the investee company.
The FI reputation for loyalty and honesty and co-operation.
The likelihood of FI success in influencing companies depended on FI power as well as factors such as,
Clarity of issues, and the social or political significance of the issues, Clarity of proposed solution,
FI and corporate costs and benefits of dealing with the issues,
The FI style of influencing - public vs private, constructive vs confrontational.
Ability to gather other FI support.

The size of the stake became very important when it began to exceed 10%, and this factor began to 'overwhelm' the impact of the other factors above. At about a 2%, the stake size did not appear to be as important as these other factors. This was the dominant stakeholding policy adopted by the case FIs, especially with FTSE350 stocks.

FI influence was normally exercised in a covert manner, in the background, but understood by participants in a meeting or a relationship. The use of FI power was explicit in confrontational and conflict interactions but not in the more normal 'relationship' or co-operative interactions. Influence based on these factors could be boosted by 'market forces' influence. Thus the potential threat of stock sales to hostile shareholders or predators could reinforce these relationship influence factors.

FI power increased with the existence of 'pressure points' where most influence and pressure could be exercised. These included,
-Company meetings could be used as a pressure point by using the NAPF and ABI reports on relative corporate compliance to pressurise the company.
-Situations where the company has to come to the market or to its major FI investors to ask for additional equity capital to rebuild a weakened balanced sheet.
-Situations where the company seeks to change or dilute FI ownership rights and requires FI consent.
-Situations where the company asks questions, or asks for help and support during takeover situations or other uncertain situations
-Situations where company proposes new financing method or a new voting structure.

If adverse corporate circumstances occur, then individual FI or core FI group intervention in an investee company can be stimulated, at the same time as corporate power to resist external influence declines. This can occur when,
- The company has been performing poorly for some time.
-Board and management disputes have become serious and threaten the economic health of the company. Public 'washing of this dirty linen' increases the likelihood of FI action.
-The company has been blatantly ignoring all of the CG guidelines and its financial performance has not been satisfactory.
-The FIs are seriously concerned about a major switch from a business strategy that management have promoted heavily in the recent past and which has been understood and agreed with the core FIs.

At this point, the legal model of FI-Co relations becomes dominant as the FIs exercise their property right arising from share ownership. These adverse corporate circumstances and weakened position can stimulate individual or group FI intervention. The growth of FI power can create the conditions for its recommendations to be implemented. However, there still remains the problem of organising a group of FIs to concentrate the legal power required take collective action and to ensure that implementation takes place. Cases 1 and 2 illustrated how this was done.

This approach which exploits 'pressure points' is a system of 'regulatory parsimony' where regulators could have the greatest impact for a limited amount of regulatory resource. It also locates the regulatory process closer to an existing, well functioning, monitoring processes. This emphasises more supervision or close monitoring and less central rule making or regulation (Hilton 1994, p8)

The potency of the FI lead self regulation role is further enhanced by the range of FI intervention & influence

ices concerning their investee companies.
For example in FI Case 2,

> 'If the company refuses to listen to our individual 'behind the scenes' influence, then group financial institution action and the use of public pressure mechanisms such as the media may be employed. The last resort may be to fall back on the stock market and the market for managerial control. This ranking of intervention policies reflects a UK preference for a 'private club' solution rather than a public confrontation. Of course all methods of intervention may be present in varying degrees in a particular situation. We also foster close relations with about half a dozen journalists. We use them and they use us. We use them to put a slant on stories and they probe us for new stories or opinions on company prospects and management personalities. All of this is normally 'off the record'

Many of these intervention & influence choices are available in relationship, 'pressure point', and corporate weakness situations. In addition the case FIs could employ a combination of these intervention and influence methods to increase the pressure on investee companies

5.5 The FI costs and benefits of acting as the lead self regulator:

The case FIs incurred additional costs when acting as lead regulators. They also received some additional benefits. The indirect costs of regulation or the costs of compliance borne by case FIs can be categorised as follows
-the FI's administrative costs of responding to regulators questions such as the NAPF CG survey,
-direct payments to the regulatory bodies. This includes extra FI costs for supporting the CG monitoring services of the NAPF and ABI
- additional investment in staff skilled in 1:1 meetings, extra costs of setting up internal training, of writing their own internal code, of setting up specialist FI roles to monitor company compliance, of physical space for meetings, and of telecom facilities.
-the costs incurred by expending considerable FI time and effort in dealing with problem companies and by raising compliance issues with the set of portfolio companies
-the cost of lost business opportunities by spending much time on problem companies
-Legal expenses incurred in removing management or board members or in dealing with contractual structures.
-AGM costs for contested voting
-costs incurred with investee companies in that they may trust the financial institution less because of its intervention elsewhere.

The FI benefits of its lead self regulatory role included,
-Cadbury and the professional body guidelines heightened the profile of CG issues and strengthened the FIs hand when seeking corporate CG changes.
-The case FIs also found it easier to form a collective influence or intervention group when the CG issue arising in a company was one that had the strong support of Cadbury behind it.
-Actively intervening in some companies and explicitly influencing them encouraged other companies to behave and perform well.
-There were some reductions in overall monitoring costs as FIs became more professional in this area.
-Portfolio returns were expected to slightly increase as the FIs became more adept at identifying companies with costly CG problems and possible poor financial performance and could thus screen these out of their portfolio.
-Benefits could also include extra tax reductions because the FI was now able to claim more tax deductible expenses arising from its lead role.

These indirect costs and benefit categories are similar to those identified by Franks and Schaefer (1994). Much of these costs and benefits overlapped with FI costs and benefits of a corporate research and intelligence programme. It was not clear from the cases which of the above costs and benefits were true incremental changes arising from the new Cadbury self regulatory role, or were those that arose from new 'good' practice stimulated by the adoption of this role, or from new 'good' practice arising independently of this change. The case data was insufficient to provide figures on these cost and benefits and to assess whether net costs or benefits prevailed.

Costs and benefits and investment policy:
The extent to which the case FIs pursued influence and intervention on CG issues depended on their investment policy. This in turn affected the FI costs and benefits of intervening. If the FI was primarily a trader and had little resources for intervention then it was likely to sell when CG problems arose. Every case FI adopted this trader view with the transaction oriented portion of their portfolio of their investee companies. In the case of Unit and

estment trust FIs the transaction or trader portion of their portfolio was significantly above 50% of their portfolio of investee companies by value with a much smaller portion in stable stakeholdings.

In the case of Life and Pension Fund FIs this trader portion was less than a third of their portfolio by value and these FIs preferred a 'stable stakeholding with topping and tailing' policy as their dominant investment policy. This was where they had the bulk of their co-operative relationships with investee companies and where they expended most effort and cost on influencing CG compliance. They also held large, relatively illiquid stakes, in a limited number of smaller and medium sized companies and referred to this as 'relationship investing'. This mix of investment policies was explained by the case life and insurance FIs by their need to match to match the duration of their investments to the long term nature of their pension and insurance liabilities.

The differences in portfolio composition led the Unit and Investment trust FIs to have different styles of CG influencing to the Life and Pension Fund FIs. The latter FIs were more active, and incurred greater influence and intervention costs, and adopted a more relationship, and behind scenes approach. The major CG lead regulator costs were borne by Life and Pension Fund as individual FIs and NAPF and ABI were the most active professional bodies. Unit and Investment trust FIs 'piggy backed' to some extent on the efforts of Life and Pension Fund FIs in the CG area.

It was in this relationship portion of their portfolios that the case FIs argued that they were now very active concerning CG issues. They used these existing co-operative links to pressurise investee companies to comply with Cadbury, as well as with professional body and individual FI codes on corporate governance. In addition, the case FIs used the market pressure threat as an additional discipline for their relationship oriented or core portfolio companies.

The dominant approach in the FI cases was to be pro-active with relationship companies on those CG matters that had low influence and intervention costs such as the separation of chairman and chief executive and on general compliance with Cadbury. This was the most likely policy to be adopted to change CG standards in good performing companies. The case FIs showed no tendency or desire to interfere in depth in the management or strategy of good performing investee companies. Thus the fund management net benefits of close working relationships with these companies outweighed any net benefits from a rapid adoption of CG standards.

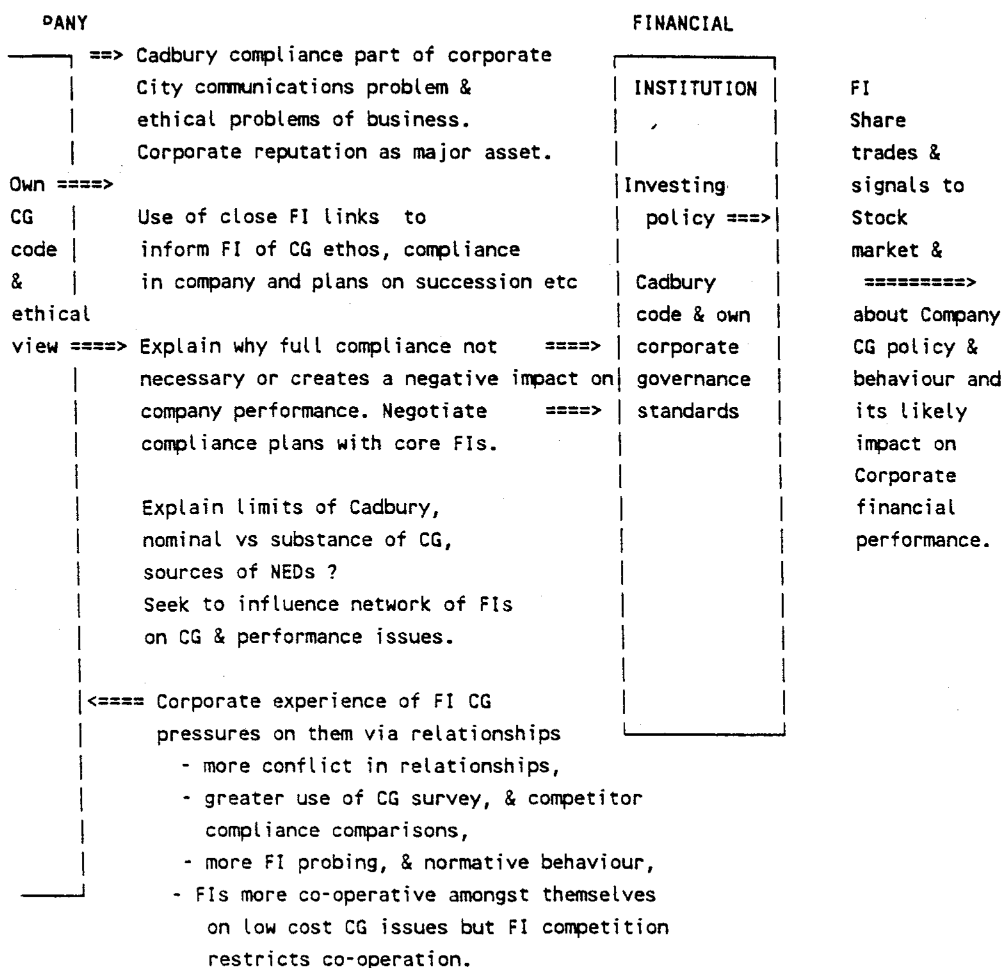
It was also common for the UK case FIs to screen out all weakly performing companies from their portfolio, and those companies likely to incur high CG monitoring costs for the FI. The residual problem companies were then targeted by the FI for financial and CG advice. The remaining companies in the portfolio received advice on financial performance and CG standards expected of them, so that they had time to avoid becoming problem cases. These case FIs were therefore seeking to apply influence on these matters long before the company required it and it became a problem. This kind of influence was considered to be most effective when exercised in a relationship context. The case FIs were therefore seeking to minimise their costs as lead self regulator. The FIs were also signalling to the stock market and to its investment management clients that it was taking action long before expensive CG problems arose.

6. Corporate use of close FI links in the self regulation of CG :

In the following sections we take a brief look at how the case companies handled the CG pressures from their core FIs.

6.1 Patterns of case company behaviour:

In the following diagram, the corporate case data is summarised and used to illustrate broad patterns of how the case companies tried to manage the CG pressures and influences from their FIs. In section 6.2 corporate cases are use to show how the companies tried to discuss and negotiate these issues with their core FIs.



6.2 Company cases:

Company Case - 1

'We now find that the financial institutions and their fund managers have a tendency to lecture us on a series of issues. These include remuneration issues, contracts and corporate governance issues. For example, they do not like contracts for top management to go out beyond three years and they prefer two years, although they will accept a three year contract.

On corporate governance issues, they want to know how we are going to comply with Cadbury and what are we going to do about it and what are we doing about it? For example, the Prudential has sent us guidelines on how we manage our foreign exchange risks. They make it absolutely clear that we should not speculate. They also ask us to disclose what our foreign exchange position is and the kind of foreign exchange risk management methods we might use. We can think of many other financial institutions that behave this way and go into some detail with their own Cadbury Compliance Officer.

There is much more confrontation and conflict now being built into the more co-operative or structured relationships with FIs. It is a change in the character of the relationship. It can be characterised as the financial institution being more informed, more probing, more normative in what they think we should do and much more interested in the real business as opposed to the financial reports.

The important point about the financial institution fund managers and directors is that we see a considerable amount of networking amongst these, especially amongst the top financial institutions. Top individuals know each other quite well and probably share information with each other on corporate governance compliance. They may also share information informally on the quality of the management team and the personalities of individuals. They will not share information on their understanding of the business, its prospects, and therefore their valuation of the company. You can see that there is a dividing line between co-operation between the financial institutions

some issues and competition between the financial institutions based on their need to out-perform each other. This external networking amongst the financial institutions and amongst particularly the big ones is extremely important to us. We recognise this as an important phenomena and try to make sure that they all have a common understanding of the business and there is no misunderstanding about us between these FIs.'

Company Case - 2
'The Board structure and management structure is rather unusual here. The Board consists of 100% non-executive directors except the chairman. Beneath the Board there is an executive committee which is legally a committee of the Board. It contains all of the executive directors. We have effectively formed a two-tier board system more or less by default. We used to be anti the German idea of a two-tier board system. However, we now prefer this idea given our experience of our own internal system. In our 1993 Financial Report we went out of our way to explain why the Chief Executive and the Chairman roles were embodied in one person and how this was counter-balanced by this form of two tier board. In other words, we try to conform to Cadbury but see no point in conforming 100% when there is no benefit in terms of improved financial performance or improved corporate governance. We feel that our form of the two tier system acts as a very strong and unique governance mechanism .

In terms of corporate governance issues we think that Cadbury is not a major problem for us and to some extent the whole idea is somewhat superficial in terms of complying with a series of the Cadbury's proposals. These ideas ignore the basic issues in terms of the attitudes of management towards corporate governance, what they actually think and how they actually behave behind the scenes. We prefer to follow the spirit of corporate governance rather than the letter. We think our development of a kind of two-tier board system reflects our emphasis on the right kind of attitude, ethical behaviour and integrity in separation of supervisory and strategic roles. We think we have dealt with the substance of the issue. Requirements to separate Chairman and Chief Executive under these circumstances seems to miss the point and are somewhat superficial. We do find in the meetings with the financial institutions that it certainly has been a topic of discussion in the past year or so. They will always use the nearest and most comparable competitor as a reference point for pressurising us into compliance.'

Company Case - 3
'Corporate governance is clearly an important issue these days with NAPF and ABI trying to pressurise companies to establish reasonable standards here. Their major concern is the dilution of ownership rights. For example, a share option scheme for management could lead to an increase to management shares and the decline of the financial institution shareholding in the company. As a result we try to clear all these kinds of proposals through the normal mechanisms such as the investment committees before we implement such incentive schemes. We intend to comply with Cadbury and with the Stock Exchange Listing requirements for CG. We do not think it is necessary to comply 100% with Cadbury. Corporate Governance is an important issue of substance for us in terms of every day behaviour, ethical behaviour of managers and employees in the business.

However, we do not regard Cadbury per se as important. The accountants received a very rough mauling from the press for their poor auditing in the case of Maxwell and in one or two others. They therefore set up Cadbury to throw responsibility for poor behaviour back to company directors and take the spotlight off accountants. As far as we're concerned the responsibility has always been with the company directors. Cadbury hasn't changed that in any one way. Nor has it changed our general rules for ethical behaviour in the Company as part of our rules to conduct a sound business. We believe that any company must establish a decent standard of company behaviour if it intends to survive for a long time. We regard a good reputation for honesty and a high standard of ethics as part of the general advantages of the company allied with the general knowledge we have of our business, technological advantages and many other things. Such behaviour is essential to the function of good business. You have to be honest in business to survive for a long time.

Cadbury is the hook that people are talking about. The substance of corporate governance is what really counts. The recession revealed the muck in terms of the limitations of auditing, the misbehaviour in corporate governance as well as poor financial performance of companies. As a result this issue became a hot topic but the substance of corporate governance is a continuing issue for any enterprise.'

Company Case - 4
'We have seen a major change in climate in the past year or so with the raising of corporate governance issues and the increasing recognition of the rights of shareholders. Financial institutions are demanding more information and this right of shareholders is now more widely accepted than it was in the recent past. We think

should be ahead of these changes and not wait for their demands to increase. We like to be proactive in our communications with the financial institutions. We initiated the meetings with the financial institutions and not them with us. They appreciate us being proactive in this sense and they recognise the efforts we are making in respect of communications with them. We hope this boosts our reputation with them for the long term.'

Company Case - 5
'Has the Cadbury Report gone too far? To some extent the ideas of the two tier Board and of the non-Executive and the Executive Directors pursuing two different angles in the company could cause difficulties. Executive and non-executive directors should have the same aims but different skills and different outlooks. They should be interested altogether in boosting dividends and profits of the company. However, different people, with different backgrounds can be useful within this context. Under Cadbury non-executive directors could begin to think their job is Cadbury and not do the main job. They may focus on remuneration committees and audit committees and this kind of thing and forget about boosting profits.

One of the problems is where are the good non-executive directors coming from? There is clearly a shortage of them, of those active in the market place at any one time. In addition, non-executive directors should be restricted to one or two companies and should concentrate on a few businesses and then they should concentrate on the primary aims of the business and not on the Cadbury proposals alone. Companies need non-executive directors who bring something special to the party. These people may be very different to those with checking or monitoring skills.

The existing Cadbury proposals have been reasonably easy to implement for most companies hence the high NAPF survey results. However, the additional proposals from Cadbury's for internal control and for information on going concern statements could cause problems. These proposals could absorb a lot of company and Boardroom time and resources. If non-executive directors have to get involved to that level then this is a lost resource and to some extent companies will lose sight of the ball and the game they are in. Will Cadbury stop companies going bust? Not really. Those companies with bad management or those with fraudulent management will still have problems and will still go bust. 90% of companies that run themselves well can comply with Cadbury because they already have good corporate governance. Those badly managed and fraudulent companies will apparently comply with Cadbury but will not be stopped by Cadbury. Perhaps better internal control could help here.'

Company Case - 7
'Our corporate governance policy is fully outlined in our report and we have conformed with many aspects of the Cadbury recommendations. We find that financial institutions are not very interested in corporate governance with us. They are more interested in the financial performance and in the nature of the business and recent changes. It does not seem to crop up as an issue for us in the way it might for those firms that have been less compliant and less willing to consider the issues in the past. We have lots of non-executive directors, and sub-committees to deal with the major corporate governance issues and we have a very open disclosure policy. Financial institutions have other things to worry about with us and concentrate their resources on these. These corporate governance issues can be a bit of a luxury. A bit like the environmental and green issues in the past. It's a fashionable subject. And it's top priority now but it's likely to go away in a couple of years as more companies comply with Cadbury. Whilst I think that it is a box ticking exercise, it is still a good idea because it throws the spotlight on companies who are unwilling to adapt and therefore have to explain themselves in more detail now.'

7. The effectiveness of regulatory mechanisms and the growth of legal controls:

The success of their self regulatory corporate governance policies was considered necessary by the case companies and financial institutions, (both as individual enterprises and as members of professional bodies), to avoid the costs of formal statutory regulation, and to ensure that they did not lose the benefits currently available from their relationships. The latter included financing, control and support advantages for companies, and informational and fund management benefits for FIs. The threat of further legislation or state intervention was thought to be very real. If the professional level or City bargaining, discussed in section 3, fails to produce a satisfactory regulatory system we may see a more explicit bargaining on corporate governance matters between the state and the formal self regulatory authorities in the form of the SIB, the SRO and recognised professional bodies. This higher level bargaining may have been a factor in establishing the Cadbury committee. Given the British preference for this bargaining to be conducted behind the scenes (Birkinshaw et al 1990), it is difficult to assess its significance here. However, the state became more pro-active on corporate governance matters in 1994.

's was probably spurred by a growing debate on the mismatch between rapidly growing executive remuneration and relatively static corporate financial performance (Stevenson 1994).

The President of the Board of trade, Mr Heseltine, has argued that FIs do have a responsibility to 'encourage investors to invest for the long term as well as looking for short term profits. He added ' I would also ask you to accept a responsibility to ensure that executive salaries, especially performance pay, are truly earned'. He argued that investors should take an active interest in the management structure of companies they invest. Finally he rebuked those fund managers who argued that such a partnership was impossible. In most countries, he said, more stable relationships between investor and company manager had evolved (Chris Barrie, Guardian, p11 28th Sept 1994.). This speech repeats much of the Cadbury proposals. Its significance lies in explicit state intervention in a field of regulation previously left to the 'licensed' 'self' regulators. A Labour government could be expected to go much further in this direction and legislate on some corporate governance matters especially on remunerations schemes unrelated to performance.

Sir Adrian Cadbury has also warned that his committee's guidelines will have to be reviewed (p24, 1993). 'Now, if we have, in fact, captured the mood, then I believe the majority of companies will see it in their interest to comply with code and they will do so. But there is a fall back position within our report, which says that in two years' time a new body should take over from us, should look at what has occurred, should look at the Code and ask does it still make sense; are there things in that should not be in it; are there new issues have arisen and should be dealt with? At that point, if companies have not taken advantage of what we have put before them, then I suspect there will be pressure for regulation and this is why I say that I do not see this interest in governance as a passing phase. There are real concerns about control and accountability, and unless we are seen to raise standards to a point to which the great majority of people would regard as acceptable, there will be very real pressure for regulation'.

A further threat to corporate governance self regulation lies in changes in company law, arising from new company scandals or if the proposed EC Fifth Directive on Company Law takes more concrete form. Given these public policy pressures, all of these corporate and finance professional groups shared a collective interest in controlling the self regulatory system, in changing the system and in ensuring that it is seen to function effectively relative to its publicly stated aims and to satisfy public concerns on corporate governance.

7.2 Effectiveness of self regulation and the demand for additional legislation:

The internalisation of self regulatory processes by companies and financial institutions was described in sections 5 and 6. It was a means to avoid the costs of extra legislation, the costs of damaged reputations and to minimise threats to the transactional benefits of their relationships. It was also cost effective for FIs and companies in that it exploited their existing investment outlay in their close relationship. Institutional regulation of corporate governance behaviour is likely to be effective because of the close monitoring and influential position of the institutions with their investee companies. The effectiveness of this processes increases when used in combination with other corporate governance mechanisms such as the board and the stock market.

Given the existing information flow and influence possibilities and the mutual in depth knowledge of the partners, this 'behind the scenes' process is also likely to be a cost effective form of self regulation at the public policy level especially when used in combination with other mechanisms. It will not remove the possibility of error, criminal or fraudulent behaviour but it could potentially contribute to a reduction in the risks of major fraud and error in the overall corporate sector. The active and effective use of this interconnected system of (corporate governance) controls may therefore reduce the need for more formal and costly additional legislation, and for extensive monitoring and implementation of sanctions by public policy makers. This 'relationship regulation' should also raise the question how existing legislation or minor modifications to the law can enhance this micro self regulation process.

7.3 Barriers to effective self regulation at the relationship or micro level of control - Inherent conflicts and barriers to 'good' corporate governance:

There are some inherent conflicts and barriers which restrict achievement of self regulation and the achievement of 'good' CG through relationship channels. Many of these are combinations of corporate, FI, relationship and legislative barriers.

-porate barriers include,
.. Company Directors may not dispute the final terms of three year rolling contracts with departing directors, or may not oppose three year contracts with replacement directors because they perceive 'there but the grace of God go I'. They may exercise a similar influence on their own pension fund when it is developing a CG policy for itself or for its investment management service supplier.

2. For example, Company X (FD or CE) may influence its own PF managers to 'take it easy' on its CG policy with its FI investment manager. The hope is that Company X will find that its core FIs will recognise this and also 'take it easy' with Company X on its CG behaviour. Company X also seeks to avoid 'setting itself up' as a paragon of CG virtue and thus be humbled when misbehaviour occurs. The company therefore matches its behaviour to what it expects of its core FIs.

3.The Corporate Investor Relations function can be used by companies as a barrier to good CG by acting a 'buffer' to high quality communication between the FI and the Company. Thus questions are answered by communication specialists and the main aim is avoid a dialogue with FIs and others. This policy was not referred to by the case companies but the role of professional corporate 'communicators' as barriers was raised by the FIs.

FI barriers include,
1. Conflicts can occur when FIs wish to gain support on a voting contest, and decide not to support a new NED. However, they find that other FIs will not support their proposal because they manage PFs for the company in which the proposed NED is a TM or ED. They fear the loss of the investment management contract. 'I agree with you, but would prefer to give this one a miss'

2. FIs also face barriers to exercising good CG influence if the issues are complex, the costs of gaining support from other FIs are high, and the issue is new and not backed by Cadbury.

3. FI FMs may also face barriers to implementing a 'good' CG policy if their own board and top management employ poor CG practices. The FI may be offering their own EDs three year rolling contracts or option schemes which may not be directly related to the FIs financial performance. If this is public knowledge, a FM will not find it easy to vote against these practices in their own investee companies, or to support group FI action on these matters.

In other CG situations, case FIs preferred to go public, or be active 'behind the scenes' on CG issues only where
-they thought they already had a consensus with their investee companies
-they can practice what they preach
-they can avoid 'setting themselves up' as paragons of CG virtue and thus be humbled when misbehaviour occurs.
When these conditions existed they formed a (perceptual) barrier to good CG as the case FIs sought to avoid reputational loss, and credibility loss with their investee companies. This highlights the significance of reputation to the case FIs. Their reputation with investee companies was thought to depend, inter alia, on
-method of communication of FI CG policy - public vs private
-style of communication of FI CG policy - confrontational vs constructive.
For example, in section 5.3 we can see that Ross Goobey probably communicated the three year rolling contract message correctly as far the FI sector was concerned. However some of the case companies objected to his public communication method. His reputation and Postel's reputation may have suffered because of this. This policy has probably distanced the relationship between Postel and their current and prospective investee companies and Postel's future CG influence has probably declined because of the confrontational, public form of communication rather than a private, constructive approach.

Another related issue is that companies can to some extent choose which FIs they have a constructive relationship with. Two FIs, Y and Z, may have the same size equity stake of say 2%, but the company can choose to be more co-operative with FI Z. This may be because FI Z has a higher reputation for constructive, co-operative behaviour and this leads to a more effective dialogue on many FI-Co communication issues including CG. It could also be because FI Z has more agreeable CG policies and this implies some form of negotiation of reduced public pressure for CG by FI Z in return for greater company co-operation with the FI Z. The latter may mean richer information flows and perhaps higher compliance with behind the scenes FI influence. The reputational issue can therefore act both as a barrier and as a support to 'good' corporate governance'.

section 5.3 we have seen that there are reputation effects or issues with FI 'customers' in the form of pensioners or pension fund clients, if the FI issues CG or other public rebukes to their investee companies. This may consolidate their reputation with their PF clients and it may publicise their efforts here and attract in new PF clients. This may be the main motive for public rebukes especially if the rebuke is related to improving corporate financial such as reduced term rolling contracts reducing large compensation costs. The one exception to this is if the CG 'tail' is seen to be wagging the financial performance 'dog'. If FI FP declines and this is perceived to be related to extensive CG influencing and posturing by the FI then PF clients may leave.

A major corporate barrier to good corporate governance in 1994 is that some Company directors and top executives appear to have significant power to award themselves pay rises unrelated to corporate performance and shareholder returns. Stevenson (1994) reports that a September 1994 Datastream survey shows that 20 of the largest UK companies now pay their top executives twice as much in 1993 as they did in 1991. Of these 7 gave their shareholders a total return over the same period of less than 50%. This could reflect the random variation in these numbers. It could also reflect a failure of all current corporate governance mechanisms including the board, the stock market and close monitoring by institutional shareholders. The barrier in the boardroom and with institutions appears to be a failure of remuneration committees and core FIs to exercise their power to countervail that of top executives and to insist on closer ties between 'performance' pay (such as share options) and company performance. The case FIs were very aware of this issue but the evidence across large UK companies does not suggest that they have been very effective in using their relationships to moderate executive pay and relate it to performance (Stevenson 1994). This may be related to some of the other barriers noted above, in particular the use of similar FI remuneration schemes for their own top executives, a fear of losing corporate pension investment management business, management ability to influence the composition of their shareholder base and a FI preference to avoid public disputes. As indicated above, Mr Heseltine, has intervened in this debate in September 1994 and argued that FIs should 'accept a responsibility to ensure that executive salaries, especially performance pay, are truly earned'. It is clear that this is a test issue for 'relations self regulation'. If the FIs fail to demonstrate their control here through close monitoring then their arguments for self regulation will fall on deaf ears.

Existing relationships can act as a barrier. The primary FI contact is with EDs and top management and not NEDs. The case FIs do not expect to see NEDs at present. In part this is because it is not very easy for FIs to directly contact NEDs and because it would possibly be seen as a snub to EDs and top management and this may effect the relationships. In addition, because the primary FI contact was with EDs and top management, they may not relay the FI's CG message back to the full main board and as a result no action may be taken. The case FIs tried to get around this by writing to the board to ensure that their oral contacts with the top management team and some of the EDs were communicated to the full board.

The close relationships between the FIs and the board and top management may also act as barrier to good corporate governance as seen by the smaller, private investors. One example of this was the case of Yorkshire Water where the board had stamped 'not recommended by the directors' on the proxy voting cards for a new non executive director (FT, p22, September 30th 1994). The candidate wanted to raise the profile of environmental issues on the board and had strong support amongst both investors and water consumers. The institutional investors supported the board and she was not voted onto the board.

Finally, external legislation on other matters can undermine self regulation in corporate governance. The Stock exchange guidelines of the dissemination of price sensitive information and insider trading laws can impose a barrier between companies and FIs. They prevent FIs acquiring certain kinds of PS information and trading on it. However, much of the information acquired in the FI-Co relationship is not 'black and white' PSI. If PSI is received the FI has to place an embargo on dealing until the company releases it. However, the long term learning and knowledge acquired by the FI does not normally fall within the legal or SE ideas of PSI. If it were to, then this would form a major barrier to good CG.

7.4 Problems of ineffectiveness of legal and formal regulatory controls:

The case company and FI interviewees found the regulatory concepts less clear cut than implied by the form of the regulatory framework. Specifically they found it difficult to define 'good' corporate governance. Consequently in most of the cases there was considerable effort to cope with the uncertain interpretations of their actions, an effect which could have been exacerbated by the force of Cadbury which clearly puts the onus on the financial

·itutions as lead regulators for corporate governance :

Cadbury places the onus of financial institutions to act as lead self regulator on corporate governance. The 1993 NAPF 'Corporate Governance Compliance' survey for the 250 largest UK companies suggests that compliance with Cadbury appears to be high. Stiles and Taylor (1993) confirm a similar degree of compliance in their independent survey of the top 100 UK companies. Unfortunately, such high compliance does not ensure effectiveness of this form of regulation.

The case FIs queried the significance of this compliance and argued that it was relatively easy for a company to comply nominally and for the financial institution associations to collect quantitative data on compliance. However, this would not tell investors if boards and managers were likely to comply in spirit and substance. It was also very difficult to establish where to draw the line when matching Cadbury proposals to unique corporate circumstances. Thus high compliance by separating Chairman and CE roles may be inappropriate for a particular company. Corporate governance had to some extent be tailored to each company.

They also argued that their direct contact with management offered some benefits over Cadbury compliance,

FI Case 4,

'Cadbury is good at picking up data on tangible and clear cut aspects of corporate governance but not what goes on behind the scenes. In contrast, the meetings with the companies are better at dealing with some of these issues. They are better for acquiring qualitative data on corporate governance. They are good for checking to see that the company has complied or intends to comply with Cadbury and whether it intends to comply in spirit and in substance with the general idea. This can be gleaned from the kind of attitudes and statements made by managers in the meetings. These contacts support the structured approach of Cadbury with the more flexible and more relaxed context of the one to one meetings and tries to fill in the flesh around the Cadbury skeleton. As a result the meetings are extremely important in thinking about corporate governance issues and trying to get the ideas over to the company that we expect of them. We try to avoid corporate governance extremes such as the Company Y case where we had to vote off the Board at the AGM. The board is not the best place to deal with these problems. We try to pursue a more gentle persuasive process of corporate governance through meetings and other contacts with the companies. One thing we do try to do is to emphasise more disclosure about operational issues and other aspects of the corporate governance. For example, we do not get too concerned about the issue of three year rolling contracts for chief executives and senior managers. However, we do emphasise that we would like to see the full nature of these contracts disclosed. '

and FI Case 5

'To some extent we can see that Cadbury involves 'ticking boxes' in terms of whether they have separated out the Chief Executive and Chairman roles and whether they have established the various committees and whether their remuneration policy is okay, etc. This checking or ticking is necessary in the short term to ensure that the firm has established these checks and balances in the corporate governance system. The long run aim of Cadbury must be to change behaviour of management and of financial institutions and ensure that there is a higher degree of accountability of the firm to at least the shareholders as one of the stakeholder groups.'

'The one-on-one meetings we have with companies, are a sharp contrast to the Cadbury approach to corporate governance. Corporate governance is always on the agenda in these one-to-one meetings between the financial institutions and the company. Accountability to the shareholders is central to whether the business is being run properly for the shareholders. It is therefore an unavoidable topic at these meetings. The financial institutions wish to stop excesses that have occurred in the past decade.'

'Investor relations mechanisms for corporate governance such as the one-on-one meetings have many advantages. They are private, they are flexible, and they ensure that corporate governance and financial performance issues are dealt together the way they occur in practice. The momentum in a cycle of one-to-one meetings over the year and in a reporting cycle meant that there is a continuous agenda on the state of the business, changes in consumer behaviour, changes in the retail market and on corporate governance. There is continuous monitoring of the firm by external investors through these cycles of meetings and reporting. '

8.The combination of regulatory controls and corporate & FI experience of these as interconnected control systems:

The limitations of each regulatory mechanism, and the benefits of combining them, provided strong incentives for

case FIs and companies to see the law, 'good practice' guidelines, individual FI-Co relations, the media and the stock market as different but interrelated mechanisms to deal with the CG regulatory issues arising at the interface between FIs and their investee companies. From the perspective of the case FIs and companies they constituted an interconnected system of controls over the area of corporate governance. The legal structure provides the (FI) shareholders with legal powers stemming from their ownership rights. The Cadbury Committee, its report, and the professional codes of conducts, are backed by considerable professional legitimacy and authority. They are also backed by the threat of further, onerous legislation, if the guidelines fail. These elements constitute the more formal aspects of the control or regulatory system as observed in use in the cases. In addition, the existing set of close FI-Co relationships were the channel through which these regulatory pressures were applied. Close relationships were active transaction channels for extensive reciprocal exchanges of capital, information and influence between companies and FIs. As such they were a convenient and natural point to self regulate these parties on corporate accountability to investors. Finally, the social networks in the City and between senior managers, formed a social context for exercising control over deviant corporate governance behaviour. All of these controls are buttressed by rapid stock market reactions to new public information, by the 'market for control' and the 'market for votes' as well as by constant media monitoring.

The case FIs and companies used these CG control mechanisms to buttress each other and to provide support to each other in the pursuit of their CG aims. FI-Co relations were a means for the market and media pressure, law, statutory self regulation and 'club' SR, to be employed together at the micro level of a single company. The use of such combinations was common in the cases this was seen as a more effective overall regulatory system than the use of one mechanism alone. In particular, close FI-Co relations were seen as compensating for weaknesses (of definition, of acceptability, of measuring deviations from desirable behaviour) identified in legal and Cadbury and professional body self regulatory mechanisms. They were also available when market pressure options were not available. They complemented the market pressure, legal and statutory SRO mechanisms when used by the case FIs and increased the self regulatory degrees of freedom open to the FIs. This is similar to Streeck & Schmitter's (1985) view that a diverse set of regulatory mechanisms can increase the strategic alternatives for the solution of public policy problems. The range of mechanisms offers similar choice benefits at the level of the individual company and FI, as well at the level of public policy.

9. An alternative to legislation:

Despite the problems of legislation and self regulation, additional legislation in the corporate governance field is not the obvious way forward. In the previous sections we have seen that,

1. The case data has provided a micro level view of how regulatory policy is being implemented in the UK and the costs and benefits for FIs as lead self regulators. This provides some understanding of the problems the regulatory changes have created for FIs and companies and how they have adapted their existing decision processes and relationships to incorporate the new regulatory constraints. The cases also provided some insight into corporate and FI incentives to make self regulation work. The FIs and companies each had reputational incentives to use their relationships to ensure compliance with externally set standards of behaviour. They also had incentives to behave in this way to ensure that FI-Co links were not compromised and could continue to be used to beneficially support FI fund management decisions and corporate financing decisions. They also had group or professional body incentives to support successful self regulation because this could help them to avoid the costs of formal statutory regulation in CG areas.

2. This internalisation of self regulatory processes by FIs and companies was cost effective for them in that it exploited their existing investment outlay in their close relationship. Given, the existing information flow and influence possibilities and the mutual in depth knowledge of the partners, this 'behind the scenes' process is also likely to be a cost effective form of self regulation at the public policy level especially when used in combination with other mechanisms. This is a form of 'regulatory parsimony' where (corporate and FI self) regulators have the greatest impact for a limited amount of regulatory resource. It also locates the regulatory process closer to an existing, well functioning, monitoring processes. This emphasises more supervision or close monitoring and less central rule making or regulation (Hilton p8, 1994). This 'relationship regulation' should both reduce the need for additional legislation and raise the question how existing legislation or minor modifications to the law can enhance this micro self regulation process.

3. The problems of effectiveness of legal and formal regulatory measures and the related problem of trying to

ıerate regulatory formulae for problematic situations, lend support to the UK notion of trying to set up ..sponsive and flexible controls at the level of the firm and its links with FIs, analysts and the media. At the minimum this approach has little to lose. Despite its own limitations, it may compensate for the limitations of the other regulatory mechanisms and the combination of this form of self regulation and law may be more effective than one mechanism alone.

4. The first two year (1993-95) implementation stage of Cadbury may appear to be unsuccessful, because of new scandals, or poor nominal compliance and these may be a stimulus for further legislation. However, this may be at the cost of ignoring substantive, ongoing influences and changes in corporate and institutional behaviour through the 'behind the scenes' process. It may also threaten such a process by undermining the co-operative links between institutions and companies.

In contrast, R Davis's (1993) proposal for setting up a single body (a 'Corporate Governance Panel') comprising of representatives from all City institutions, especially institutional shareholders and lenders, appears to be a suitable alternative to additional corporate governance legislation. This panel could build on the existing 'behind the scenes' process by directly monitoring the corporate governance self regulatory process outlined in this report. Its primary focus should be on the continuous self regulatory process and how it provides an effective form of self regulation. This monitoring should provide a pool of good practice as the basis to progressively develop the Cadbury code in a non legalistic way. The panels could also be the first point at which controversial issues or apparently deviant behaviour are dealt with. Learning by the panel could form the basis for legislation. UK accounting, finance and financial system law consists of a framework that is rounded out and revised by new case law judgments in the courts. This means that a large amount of detail has to be completed by professional regulatory groups. (Willmott, 1985). The panel could provide the necessary detail in the area of corporate governance. Public reports on performance and independent audits of the effectiveness of such 'panels' appears to be a better route forward than the adoption of the highly legalistic, and somewhat bureaucratic system for corporate governance area. However, if open public accountability is missing for the 'monitors of the monitors' and 'self regulation by moonlight' (Birkinshaw et al 1990) remains in place, then legislation seems inevitable in the public opinion climate of the mid 1990s.

Conclusions

This paper has investigated a private or 'Behind the scenes' self regulation process outside of the more public form of self regulation overseen by the SIB. This form of self regulation was exercised by FIs relative to the Cadbury Report on corporate governance (December 1992). The focal point for this private self regulation process was the close co-operative relationships existing between financial institutions and their portfolio companies.

These close relationships were active transaction channels for, and the means to govern, extensive reciprocal exchanges of capital, information and influence between companies and FIs. As such the relationships were a convenient and natural point for these parties to self regulate each other on corporate governance. The financial institutions acted the lead self regulator. Self regulation was therefore conducted within a complex relationship context in which companies were pursuing broader financing and City communication aims, and FIs were pursuing research and fund management aims. This research, by modelling this micro phenomena of FI-Co relationships, provides an important reference point around which these self regulation processes can be discussed and analysed. Without such a reference point it is difficult to envisage how self regulation can be analysed at this level.

Extensive case study data was used to identify patterns on how co-operative relations were used to ensure that investee companies and FIs adhered to externally defined corporate governance standards. This self regulatory process was illustrated by example FI and corporate case studies. The case data also provided some understanding of the costs and benefits for individual FIs when acting as lead self regulators on CG.

Close corporate relations were central to the corporate governance control role of the case FIs. Regular contact with investee companies by core FI shareholders was an important means for FIs to identify problems, to influence the company, to intervene early, and to prevent an investee company from sliding into poor performance. They were also a means to observe managerial behaviour and influence it towards 'good' corporate governance standards. Thus the case FIs used close corporate relationship to ensure that managers and boards did

over consume perks or make poor succession decisions and generally complied with accepted corporate governance standards. These control possibilities indicate that the UK financial institutions have developed an early warning corporate governance system that is similar in substance but different in practice to the German lead or Haus bank. It was not clear from the data whether the case FIs systematically used this system in a pro-active sense. However, there were many examples of the case FIs using their relationships to precondition their investee companies before problems arose. Thus the case data reveal the considerable 'Behind the scenes' efforts of the case FIs and companies to avoid the problems of fraud, misuse of confidential information, price manipulation, despotic managerial behaviour, excess risk taking, and other financial malpractice evident in recent events.

The cases also reveal how the 'behind the scenes' self regulatory mechanism can interact and be combined (by companies and FIs) with market pressure, legal controls, statutory self regulation, and professional body self regulation. The use of such combinations was common in the cases and this was seen as a more effective use of the overall regulatory system than the use of one mechanism alone. This point suggests that the public choice question concerning regulatory mechanisms should consider questions of the appropriate mix of regulatory mechanisms as well as mutually exclusive choices between mechanisms. In addition, the assessment of regulatory policy should consider the effectiveness of the broad combination of mechanisms rather than simpler combinations of say law and SROs.

In these cases we have seen how FIs have sought to make their corporate governance mechanism more effective. The cases also provide some clues as to the directions that new research might take. In particular, they suggest that interactions between the set of control mechanisms are important in remedying the weaknesses of each individual mechanism. This suggests that research on the use of combinations and their interactions will be fruitful.

In the CG regulatory areas it was difficult for the case companies and FIs to articulate absolute rules or to define internally consistent logical rules to cover all situations in which bad CG might occur. It is also very difficult to define what 'good corporate governance' is. These problems also arise for policy makers and may lead them to continue to prefer a combination of law and self regulation as a flexible means of exercising control over company and FI behaviour and as a means of learning over time where a boundary between self regulation and law can be established. The case study method appears well suited to conduct further research on these issues.

The paper has revealed the complex nature of the self regulatory process concerning corporate governance. It illustrates companies and financial institutions active use of their close links in dealing with the (self) regulation problems. This is a continuous process, in which much of the corporate and FI compliance and pressures for compliance are hidden from the public view. It also appears to involve the major UK financial institutions and companies in an ongoing dialogue. It is in sharp contrast to the highly public but unusual cases of bad corporate governance which have formed the source of much pressure for further legislation. The complexity and flexibility of the process suggest that any future legislative changes should build on this process rather than be based on short term reactions to highly public but relatively infrequent cases of error, fraud and criminality in the financial system. A suggestion was made for publicly accountable panels to 'monitor the monitors' in corporate governance. However if 'self regulation by moonlight' remains in place, then legislation seems inevitable in the public opinion climate of the 1990s.

Micro data on how self regulation is conducted is an important component of an assessment of regulatory policies. However, it must be complemented with data at the aggregate corporate and FI level if a comprehensive assessment of the interconnected (legal, professional body, and FI-Co relations) regulatory system is to be made. Further research on the micro or relational component of the UK financial regulatory system may contribute to the corporate governance, and the 'finance-industry divide' debates and may reveal more on the special advantages of this micro regulatory mechanism and how it contributes to the functioning of other control mechanisms. Finally, it should be noted that the paper indicates that UK regulatory practices are embedded in a UK context and contain a strong element of self regulation or 'Associationism' (Puxty et al 1987) at all levels. This suggests that national regulatory system comparisons may be misleading if they focus on individual components such as the law alone rather than the combined use of the whole set of control mechanisms. They may also be misleading if they ignore unique national preferences for forms of social order such as legalism, markets or community, which in turn, are likely to exercise a strong influence on the combination of domestic regulatory mechanisms employed (Streeck & Schmitter 1985).

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