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Introduction

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Corporate governance, a term that scarcely existed before the 1990s, is now universally invoked wherever business and finance are discussed.¹ The subject has spawned consultancies, academic degrees, encyclopaedias, innumerable articles, conferences and speeches. Almost all the OECD nations are currently revising their corporate governance practices or have recently done so (OECD, 2003), while the establishment of a viable corporate governance system has become a priority objective for emergent economies from Latin America to China. In the midst of so much interest, the underlying issues of the subject are always in danger of being swamped. Moreover, since 'good governance', like 'fair trade' and 'free competition', is an abstraction that commands near-universal respect but diverse interpretation, it has also become the destination board for a bandwagon carrying those who would, in fact, take the corporation in myriad directions.

Not merely does the term corporate governance carry different interpretations, its analysis also involves diverse disciplines and approaches. For example, the behaviour of senior managers is variously constrained by legal, regulatory, financial, economic, social, psychological and political mechanisms which are themselves sometimes substitutes and sometimes complements. Academic researchers, predominantly coming from a single subject background, will typically explore the operation of merely a subset of these and then in the context of the priorities of their own discipline. This inevitably means that research on the subject becomes Balkanised and less accessible.

The quantity and variety of material being produced on corporate governance has forced us to be selective in compiling this volume. The book aims to bring together scholars from a variety of backgrounds, particularly accounting and finance, economics and management, to present a series of overviews of recent research on issues within corporate governance and on governance developments within particular countries and institutional regimes. Coverage of the subject has inevitably involved a trade-off between breadth and depth, and in largely restricting ourselves to these business disciplines we have been mindful of the need for coherence. This is not to say that other perspectives, perhaps drawing upon social sciences including politics and sociology, would not have a valid contribution.

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Since corporate governance carries such a wide variety of interpretations, it seems appropriate to begin by setting out the approach generally adopted in the volume. Here it is assumed that an effective system of corporate governance has two requirements, one micro and one macro: at the micro level it needs to ensure that the firm, as a productive organisation, functions in pursuit of its objectives. Thus if we follow the traditional Anglo-American conception of the firm as a device to further the well-being of its owner–shareholders, good governance is a matter of ensuring that decisions are taken and implemented in pursuit of shareholder value. Importantly, this involves actions that reconcile the need to protect the downside risk to shareholders (that is, accountability of managers) as well as to encourage managers to take risks to increase shareholder value (that is, encourage managers to act entrepreneurially (Keasey and Wright, 1993)). If the purpose of the firm is modified, perhaps to accommodate the interests of other ‘stakeholders’, including employees, suppliers etc., the objective changes but the need for mechanisms to further this objective does not.

At the macro level corporate governance, in the words of Federal Reserve Chairman Alan Greenspan: ‘has evolved to more effectively promote the allocation of the nation’s savings to its most productive use’.² Thus in financing corporate activity, whether through equity or debt, savings are channelled into productive activities, the return on which ultimately determines national prosperity. The recent US experience with Enron, WorldCom and other failures is a reminder that if failures at the firm level are sufficiently serious and/or widespread, there will be a misallocation of funds in the short term and systemic consequences for longer-term investment if confidence is damaged.³ Similarly, a major problem for transition economies has been to create governance systems which engender sufficient trust to allow private savers to supply local entrepreneurs with their funds.⁴

ALTERNATIVE PERSPECTIVES ON CORPORATE GOVERNANCE

Whether success at the micro and macro levels is separable is itself very much part of the debate. It reflects, in particular, the individual’s perception of the nature of governance and the degree of confidence held in the efficiency and effectiveness of financial markets. We might broadly distinguish four perspectives in the governance debate: the *principal–agent* or *finance* perspective, the *myopic market* view, the *stakeholder view* and the *abuse of executive power* critique.⁵

Those approaching corporate governance issues from a *principal–agent* or *finance* perspective, following Jensen and Meckling (1976), see governance arrangements, including the apparatus of non-executive directors, shareholder voting etc., as devices that the suppliers of finance require to protect their interests in a world of imperfectly verifiable actions. Jensen and Meckling (1976) consider the case of a 100% owner–manager considering the sale of an equity interest to outsiders. As the original owner’s share falls, so does the incentive to exert effort to generate shareholder wealth. In the absence of any controls on the owner–manager’s anticipated post-float behaviour, the issue price of outside equity would fall to reflect the corresponding threat to shareholder wealth. Therefore, with full anticipation of the consequences of the manager–shareholder relationship the total *ex ante* cost falls on the would-be issuer of outside equity, that is, the owner–manager. This generates a corresponding incentive to introduce devices to control and monitor managerial behaviour – that is,

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to establish corporate governance arrangements – at least up to the point where the marginal cost of so doing equals the marginal benefit. On such a view, an efficient capital market will generate effective governance arrangements without the need for external intervention.

It follows that those adopting this principal–agent perspective tend to see unrestricted capital and managerial labour (Fama, 1980) markets as the most effective checks on executive malperformance. On such a view, well-functioning capital markets will tend to solve both the micro-level governance problem and, by directing funds to the use of those managers that appear to offer the best risk–return combinations, ensure compatibility with the macro-level objective of efficient funds allocation.

Conversely, those who view the capital market as fundamentally flawed and *myopic* in its concern for short-term returns, argue that purely private bargaining between a firm’s owners and the supplier of funds will not produce effective governance. On this view, a myopic stock market encourages managers to underinvest in long-term projects. Effectively a higher cost of capital is applied than is strictly economically justifiable, thus screening out many longer-term investments. This problem is intensified in environments where a hostile takeover threat – see below – further restricts managerial discretion.

Adherents to the *myopic market* position unlike, say, supporters of the *stakeholder* view do not necessarily question shareholder value maximisation as an objective. What they do conclude, however, is that in the presence of a myopic capital market there is likely to be a macro failure of corporate governance in that there will be systematic distortions of investment in the economy to the detriment of long-run growth. On such a view insulating managers from stock market pressures will also benefit shareholders in the longer term. Thus some myopic market critics would endorse the involvement of other stakeholders – for example, employees – in governance not necessarily to further the interests of the latter themselves, but where these might have interests that favoured long-term projects.⁶

Proponents of the *stakeholder* perspective contend that the traditional Anglo-American view of the firm’s objectives is too narrow and that it should be extended to embrace the interests of other groups associated with the firm, including employees, community groups etc. These stakeholders are considered to have interests that depend, in part, on the continuing development of the firm. Therefore, a governance process that offers no explicit voice to such groups is unlikely to take sufficient account of their interests. On this view, it is the firm objective of unalloyed shareholder value-maximisation that leads primarily to a micro failure of governance arrangements.

Finally, there is a view that corporate governance reforms should be used to restrict, if not prevent, the pathologies that arise from the *abuse of executive power*. Supporters of such a position may variously hold to shareholder value or stakeholder interests as the optimal objective for the firm, but they suggest that the pursuit of any such objective may be flawed if dysfunctional behaviour by senior executives emerges. On such a view executives may be able to exploit situations that were simply unanticipated or even inconceivable at the time of share flotation. Governance arrangements can be created to reflect principles of transparency, representation and a division of responsibility, but there will be a need for a periodic reform of procedures to reflect evolving circumstances in the firms themselves. While the misuse of power by the CEO of firm A is primarily a micro failing, perhaps hurting firm A’s shareholders, bondholders, pensioners or employees, if the As are too big or too numerous the problem develops into a systemic macro one.

*Corporate Governance***BACKGROUND TO CORPORATE GOVERNANCE REFORM**

In the early 1990s much of the debate on corporate governance concerned the alleged weaknesses of the Anglo-American corporate form (see Charkham, 1994). In economies such as the USA and UK, with liquid stock markets in which the overwhelming proportion of shares were held by financial institutions, it was widely assumed that monitoring of managers would be deficient. Shareholders, whose investments were held in diversified portfolios, were considered to have weak incentives to involve themselves in information collection and participation in company AGMs etc. Here the dominant strategy for individually dissatisfied investors was to utilise the opportunities generated by a liquid stock market and exit. In the face of diffused shareholder power the divorce of ownership from control, long ago identified by Berle and Means (1932), was assumed to be the norm. Managers thus had considerable discretion to further their own interests in ways that included diverting cashflow to preferred investments, often involving unnecessary diversification or the undertaking of entrenching activities, and in giving themselves overly generous salary and bonus rewards.

While the takeover threat was always present for underperformers – and probably remained quite potent for the more egregious examples – the takeover is a blunt and costly instrument and the probability of being acquired falls with size. Indeed critics pointed to the high apparent failure rate among takeovers to suggest that the market for corporate control was as much a part of the problem of inadequate monitoring as it was a solution.⁷ Value-destroying mergers were interpreted as evidence of managers furthering their own aspirations for growth at the expense of the shareholders. Furthermore, in the UK at least, a series of high-profile corporate failures involving the apparent misuse of executive power by domineering CEOs such as Robert Maxwell and Asil Nadir pointed to the absence of effective checks and balances.

Nor did the Anglo-American corporate form escape criticism at the macro level. It was widely noted by its supporters and critics alike that executives were ultimately constrained by the ease of shareholder *exit*, employing the term of Hirschman (1970). Dissatisfied shareholders would sell and if they did so in sufficiently large numbers the share price would fall and the firm's assets would ultimately become attractive to some rival group of managers who would thus bid for them, perhaps via a hostile takeover. Supporters saw this 'market for corporate control' (Manne, 1965) as a key check on managerial malfeasance or incompetence. Critics complained it engendered perverse incentives. They pointed out that even a poorly performing target firm's shareholders could usually expect some recompense for past underperformance via a bid premium, thus further eroding their incentives to participate in the monitoring of management. The principal losers appeared to be the target's senior management, many of whom would lose their jobs. Critics (for example, Charkham (1994)) argued that such a fear, coupled with perceived myopia in the capital market, encouraged a short-termist attitude in the Anglo-American corporate form. This was contrasted with lending-based systems such as those in Japan and Germany, countries where stakeholder representation is also more pronounced and where finance is typically supplied by a bank in a long-term relationship with its client firm.

Thus it was argued that in firms financed by debt and/or retained profits managers could afford to take a longer-term perspective and invest in physical and human capital without day-to-day concerns about the consequences of share price falls. While this short-termist charge remained highly contentious, not least because it implied serious capital market inefficiency,⁸

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it became quite influential. This was not least because its supporters could point to the superior performance of the German and Japanese economies in the 1970s and 1980s, in comparison to the sluggish growth in the US and UK.

GOVERNANCE REFORMS: THE EARLY DAYS

The modern process of corporate governance reform can be said to have started in the UK with the establishment of the Cadbury Committee (on the *Financial Aspects of Corporate Governance*) in 1991. It was set up in response to three inter-related areas of concern in the existing arrangements: first were anxieties over the use of 'creative accounting' devices, which were believed to be obfuscating the calculation of shareholder value (Whittington, 1993). Second were concerns over a string of corporate failures, particularly those associated with high-profile, domineering CEOs who were apparently able to conceal financial weaknesses through the opacity of their control mechanisms. Finally, there was a growing public unease over the rapid growth of executive remuneration, especially an apparent failure to relate increases more strongly to firm performance (Keasey and Wright, 1993).

Cadbury's recommendations, which are explored in detail by Keasey, Short and Wright in Chapter 2, centred on ways to increase the accountability of executives. Thus the Committee proposed a series of reforms designed to decentralise power within the firm and to increase the role and independence of non-executive directors in the monitoring of executives. These included the splitting of the functions of chair and CEO and the establishment of a series of main board committees, to be dominated by non-executives, which would take responsibility for organising the audit function, executive remuneration and the nomination of future non-executive directors.

In the UK and elsewhere Cadbury has been followed by further moves to strengthen the indirect *voice* of shareholders by enhancing further the role and independence of non-executives. There is a growing realisation that independence is compromised where directors remain in-post for too long, spend too little time on their duties to understand the complexities of their firm's activities or where the executives remain in de facto control of non-executive appointments. Thus successive corporate governance reviews have introduced limited terms of appointment (Greenbury, 1995), redefined responsibilities and suggested still more independent recruitment procedures (Higgs, 2003).

Executive pay arrangements offer a particularly interesting proving ground for corporate governance reforms. From Cadbury onwards, successive reformers have tried to increase the transparency of the pay-setting process, distance it from the influence of affected executives while generally looking for a pay determination process which strengthens the link between rewards and corporate performance. However, they have also had to accept that executive pay remains a market price, determined by a managerial labour market where companies are in competition for scarce talent. Therefore, harsh restrictions on the permissible provisions of a managerial contract could restrict a company's ability to hire international talent.

In institutional terms, Cadbury established the principle of a non-executive director-dominated remuneration committee, which would have access to outside pay consultants and be accountable to the shareholders' AGM. However, executive rewards continued to increase post-Cadbury,⁹ often spectacularly. In the mid-1990s this was driven by option gains. The use of executive share options had spread from the US, to the UK and beyond in the 1980s.

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This development was widely seen by contemporaries as a governance improvement in that options directly tie the rewards of the manager to the well-being of the shareholders and hence more closely align the interests of principal and agent.¹⁰ However, the bull market of the mid-1990s generated option gains for all, even those whose companies did not appear to be particularly successful. In the UK, particular media wrath was heaped on the 'fat cat' directors of newly privatised utilities, for example regional water distributors, who were seen to enjoy a very substantial growth in rewards over this period. These companies' share price growth did not appear to be indicative of especially good entrepreneurial management. Their primary activity was scarcely competitive: each was a monopoly supplier of an essential commodity at a generously regulated price and their newer activities were often wildly unsuccessful diversifications purchased with the shareholders' money.

Thus in the UK at least executive stock options were widely seen as insufficiently discriminating between well-run and mediocre firms. In a bull market almost everyone benefited; while in a bear market options would soon become overpriced ('out of the money' or 'underwater') and irrelevant and need to be replaced by new option grants with a more generous strike price. Following another report (by Greenbury (1995)) the emphasis was moved to long-term incentive plans (LTIPs) under which grants of shares (and/or cash) typically depend upon the benchmarking of the firm's performance against that of a sample of rivals over time. LTIPs were soon adopted and substantially displaced options. However, early attempts to assess the effectiveness of LTIPs in aligning executive rewards more closely to firm performance (see Bruce and Buck, Chapter 6) suggest they have been largely unsuccessful.

In the US, where stock options have long been a major element of executive remuneration, concern has been less with the level of option gains but rather with the size of option grants. These anxieties intensified after the Enron debacle where, in 2000 immediately prior to the corporation's collapse, it emerged that executive option grants covered some 96m shares, or 13% of common shares outstanding. This gave rise to two major concerns: first, that options were not being clearly expensed in the firm's accounts and hence that they were made to appear to be a costless way of remunerating managers, rather than a dilution of shareholders' equity. Second, it emerged in the Enron case that very large tranches of option grants may encourage earnings manipulation. It became apparent that the senior executives had strong incentives to ramp up the share price prior to the exercise date for these major blocks of options. The Sarbanes-Oxley Act (2002) has directly addressed both issues.¹¹

The corollary of paying for success is not rewarding failure. In addition to finding a satisfactory way of encouraging managers to boost firm performance, corporate governance reformers have been concerned to reduce the pay-offs to sacked managers. In the early 1990s pressure for reform came from institutional investors under the leadership of Hermes Asset Management which wrote to the FTSE 100 announcing its intention to vote against the then typical three-year rolling contracts for executives. These contracts had the effect of ensuring that any sacking was likely to involve extensive compensation. Greenbury (1995) endorsed these concerns and recommended that directors' notice should not exceed one-year rolling. PIRC (2003) reports that the 'immediate effect' of the post-Greenbury best practice guidelines, supported by institutional lobbying, was a reduction in the length of the typical executive contract to two years. The DTI green paper recently reported that notice periods have continued to fall such that by 2002 some 80% of FTSE 350 executives were on a one-year rolling contract.

A reduction in the notice period clearly has the effect of lowering the severance pay-off. However, there remains an issue about what compensation is appropriate for fired executives,

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some of whom will be losing jobs which may prove difficult to replace, for reasons beyond their control. Two alternative approaches exist for determining compensation. Under a *liquidated damages* arrangement the contract specifies a formula detailing compensation in the event of termination by the company. By contrast, *mitigation* involves reducing severance pay in recognition of the outgoing manager's opportunities for earnings *prior* to the completion of notice and, more controversially, in recognition of any poor performance suffered by shareholders. Penalising failed managers strictly requires the use of mitigation, but appointing risk-averse individuals to senior positions usually requires a contract that details compensation in the event of termination and proving managerial failure in a court or employment tribunal is difficult and costly. So reducing the rewards for failure has proved no less difficult for corporate governance reformers than linking rewards to success.

In matters of executive remuneration, as with other aspects of corporate governance, much of the effort of reform has gone into the establishment of structures and procedures intended to function on the shareholders' behalf. However, there are indications that increasing the direct voice of shareholders may be at least as effective. It was noted above that the initial pressure for a reduction in the duration of management contracts, to facilitate the easier removal of underperforming incumbents, came from institutional investors. Since early 2003 shareholders in the UK have been required to approve the remuneration committee report, detailing the remuneration packages of executive board members. The early results are indicative of high levels of institutional participation, especially where generous liquidated damage provisions are incorporated in the CEO package. Institutions have been traditionally viewed as unwilling to withhold support for the current board except where corporate performance is seriously defective. By contrast, the early votes on remuneration have shown a surprisingly high level of opposition, with at least one high-profile package being rejected.¹²

NEW PERSPECTIVES FROM THE 1990s

Much of the process of corporate reform in the Anglo-American system has been concerned with protecting the interests of outside shareholders whose diffuse holdings and reluctance to become involved in monitoring leave them vulnerable to self-serving behaviour by executives. In the 1990s interest in corporate governance issues spread to other corporate systems. If the agency problems of the Anglo-American firm stem from maturity and capital market development – that is, they generally arise when the equity holdings of the founding families have become diluted as ownership is dispersed and market liquidity permits easy exit – the problems encountered elsewhere are frequently those of immaturity and capital market underdevelopment.

The transition economies of Central and Eastern Europe faced a governance problem in the need to provide protection for minority shareholders. If outside equity was to be subscribed, the potential investors needed to have confidence that the managers of the firm would not misappropriate corporate assets. In the general absence of such confidence equity was perceived to be unattractive and priced accordingly. In 1995 Shleifer (1997) estimated that the lack of an appropriate governance system in Russia left Russian private industry valued at under 5% of the level it would have reached under western governance arrangements. The consequences of such an undervaluation included both severe underinvestment in the emergent private economy and the widespread transfer of assets at unrealistic prices. Each of these had serious implications for the longer term.

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The financial crises of 1997–98 threatened countries in Asia and beyond that had become accustomed to unprecedented growth. After years of double digit growth, economies such as Malaysia, Thailand, Singapore, Korea etc. suffered a severe shock as output fell and instability threatened the corporate sector. Companies that had financed very rapid growth with high debt obligations found these difficult to sustain in more straightened times. Furthermore, the problem had systemic implications as corporate failure brought unpaid trade creditors who themselves were pushed into failure and debtholders, including the principal banks, who were left looking at unserviced loans. That such financial contagion occurred so easily has been attributed to both balance sheet weaknesses and a governance system that left huge discretion in the hands of senior executives. The latter could finance preferred growth from compliant banks with minimal accountability to shareholders.

The third major change to the debate has been the change in the position of the Japanese and German economies, whose economic growth record could be said to have gone from ‘hero to zero’ over the period. In each case, the very absence of shareholder pressure that was considered advantageous in insulating managers from the risks of short-termism is now widely seen as contributing to a reluctance to restructure. Low growth is at least partially attributed to a system that protects managers from the need to exit from declining sectors. Close bank–company relationships that were once seen as the foundation of security are now blamed for scandals, corporate indebtedness and a financial system that is burdened with bad loans.

The result has been a convergence of Japanese and Anglo-American systems, if not in the direction envisaged a decade ago. Since 2003 larger Japanese firms can opt for a US-style governance system and almost one half has done so. Shareholder activism, both institutional and private, has increased sharply with some pension funds taking the previously unthinkable step of publicly exercising their votes against the incumbent managers. Since 1999, Yoshiaki Murakami, a former MITI official, has run M&A Consulting as a hostile takeover specialist,¹³ in a complete reversal of the country’s former corporatist tradition. In addition, restructuring activities typically associated with Anglo-American systems, notably leveraged management buy-outs, have also become a significant feature of the Japanese context (Wright *et al.*, 2003).

A similar shift is apparent in Germany. Close bank–client relationships, underpinned by cross shareholdings, bank stewardship of proxy holdings and bank representation on the supervisory boards, have come under attack. Banks are moving away from long-term shareholdings and looking to develop their more entrepreneurial investment banking arms. Shareholder voice has been extended in numerous ways, together with the rights and responsibilities of the supervisory boards. Moreover, in an echo of earlier UK reforms the appointment, tenure, and accountability of non-executive supervisory board members have been reformed with the intention of sharpening their scrutiny of the operating board.¹⁴ In both Japan and Germany, institutional and cultural factors, however, continue to constrain the wholesale shift to an Anglo-American system. In general, these institutional and cultural influences pose major questions for the diffusion and adoption of corporate governance mechanisms in different countries.

THE VOLUME’S CONTENTS

Reflecting the issues outlined in this Introduction, the chapters in this volume are essentially divided into three parts. The first part covering Chapters 2 to 7 reflects the development of the various aspects of corporate governance mechanisms, that is to say the development of corporate governance codes, the role of ownership, institutional shareholders, boards of directors

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and executive remuneration. The second part covering Chapters 8 to 10 deals with alternative arrangements to traditional internal governance mechanisms, notably the role of the market for corporate control, the role of (entrepreneurial) leadership in conjunction with corporate governance mechanisms, and newer active forms of governance notably those involved in venture capital firms and management buy-outs. The third part (Chapters 11 to 17) considers corporate governance in different institutional environments, both in general and specifically in respect of Germany, Japan, France and transition economies.

Keasey, Short and Wright (Chapter 2) chart the development of corporate governance policy in the UK between the formation of the Cadbury Committee and the publication of the first Combined Code in 1998, and then between the publication of the first and second Combined Code in 2003 and to the present day. They provide an overview of the changing approach to governance policy which has occurred since the publication of Cadbury Report (1992) and consider how current government initiatives towards greater legislation may risk harming the balance between accountability and business prosperity. They show that the developments in policy from the Cadbury Report to the Combined Code 1998 represented a shift from a narrow approach which focused mainly on accountability, to a more balanced one that recognised the need for governance systems to produce structures and incentives to allow business enterprise to flourish. However, they go on to observe that recent government initiatives provide a signal that governance policy in the UK may be about to undergo a fundamental change away from self-regulation. They caution that while a self-regulatory system has previously been criticised for failing to deliver improved corporate governance standards, there is a danger that increased regulation will simply lead to more 'box-ticking' by both companies and shareholders. Furthermore, they suggest that greater emphasis on legislation risks forcing particular governance structures on all companies, regardless of whether they are suitable for the particular circumstances of the firm. A legislative approach risks changing the 'comply or explain' ethos developed hitherto into a 'comply or else' stance which is likely to result in companies adopting suboptimal governance structures simply to avoid the threat of sanctions from failing to comply. They note that it is important to remember that while corporate governance has come to embrace those mechanisms and structures which act as a check on managerial self-serving behaviour, the purpose of doing so is to promote the efficient operation of the firm. Devices employed to improve accountability cannot be seen as efficient if they also hamper the performance of the firm. 'Good' corporate governance, therefore, needs to refer to the mix of those devices, mechanisms and structures which provide control and accountability while promoting economic enterprise and corporate performance.

Watson and Ezzamel (Chapter 3) examine corporate financial structure decisions and some of their implications for corporate practitioners and stakeholders. More specifically, the chapter examines how a firm's leverage may impact on firm value and the riskiness of different stakeholders' financial claims. In practice, how far the economic welfare of corporate stakeholders is significantly affected by corporate financial structure decisions depends on how far their financial claims are protected by legal, regulatory and governance arrangements typically available and utilised by stakeholders. This type of analysis suggests that, if the reliability of firms' financial information disclosures is assured, most debtholders can normally be confident (assuming a degree of diligence) that their contractual claims can be adequately protected via legal/contractual means. However, as emphasised by Watson and Ezzamel, firms are by their nature risky and, therefore, any number of factors have the potential to produce unanticipated business outcomes that render the fulfilling of existing contractual promises excessively costly. The chapter then goes on to examine why a broader view of the firm (as compared to a nexus

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of contracts and maximising the value of the firm from a shareholder perspective) might be more fruitful; it concludes that fundamentally all stakeholders are dependent on management maximising the value of the company given their own specific objectives.

Short and Keasey (Chapter 4) address the abilities and incentives of institutional shareholders to enhance corporate governance in larger publicly quoted companies. The Cadbury, Greenbury, Hampel and Higgs reports have all stressed the importance of institutional investors as a mechanism of corporate governance. This chapter identifies the objectives of institutions with respect to their ownership and investment behaviour, examines their incentives in terms of management behaviour, and considers whether incentives can be altered such that a more proactive corporate governance role can be achieved. The chapter concludes that although the perceived degree of institutional activism has increased in recent times, due largely to government pressure, there are many factors which act to provide incentives for institutions *not* to involve themselves in corporate governance issues. Institutions have few incentives to act on an individual basis and their so-called short-termist attitudes are in part a rational response to the market, institutional and corporate arrangements which have existed in the UK. In fact, intervention tends to occur only in cases of extreme underperformance by the investee companies and if changes in corporate governance are to be brought about, fundamental changes in the market and institutional arrangements in the UK will be required. However, in the present context it is not clear that increased intervention, especially as a response to government pressure, will significantly improve the situation because this may just end up as another 'box-ticking' exercise with little real meaning or substance.

A key element of the corporate governance process is the operation of the board of directors. A number of factors, including several cases of management excesses and corporate collapses, led to major criticism of the UK's unitary board structure in the 1990s. Ezzamel and Watson (Chapter 5) examine the duties and composition of the board of directors, with particular focus on the roles of non-executive directors in monitoring and disciplining senior executives. They outline the role of the board in mitigating agency problems and review the literature relating to the effectiveness of boards. Key themes to emerge from this literature, which is largely US based, are that CEOs have typically played a central role in selecting non-executive directors (NEDs), that outsider-dominated boards enhance board independence and power over CEOs as well as improving performance, but may demotivate managers from taking decisions that involve higher expected risks and associated higher returns, that NEDs are able to influence the process of strategic choice and control, but that boards may not have sufficient information or expertise compared to the CEO. Ezzamel and Watson point to the conflicts arising from NEDs being required to wear two hats, that is to say, to monitor senior executives but at the same time contribute as equal board members to the leadership of the company. They then consider how recent reforms of UK corporate governance regulation have served to alter the duties, objectives, composition and incentives of boards. They suggest that, while voluntary codes have their limitations, the UK experience indicates that these are more adaptable and responsive to problems arising from developments elsewhere in the corporate and financial worlds than would be possible with a formal legal code. They do, however, argue that the relative success of the UK's approach to corporate governance compared to the US has been aided by a large institutional base, fewer restrictions on shareholder voting rights and the functioning of the market for corporate control and less reliance on overly generous stock options granted to senior executives. These differences have meant that fewer UK CEOs have been able to develop the level of entrenchment and power over the board that is more evident in the US.

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Perhaps the most controversial aspect of corporate governance relates to executive pay. Bruce and Buck (Chapter 6) provide an overview of the nature and anatomy of contemporary executive pay in the UK and the significance of executive pay for corporate governance. They show that the design of executive payment systems is influenced by a number of factors apart from the promotion of strong governance and that the firm's payment regime is only one of a number of mechanisms that the firm may seek to employ in assembling a robust governance regime. They then go on to review the significant body of empirical work in this area. Third, they focus on the recent evolution of executive pay in the UK and in particular the emergence of the Executive Stock Option (ESO) in the 1980s, its relative demise and the increasing popularity of the LTIP in the 1990s, and the current situation, where the coexistence of ESOs and LTIPs is commonplace among larger corporations. They note an increasing shift from the traditional focus on alignment of incentives in terms of returns to executives and shareholders, towards a consideration of alignment in terms of attitudes to risk. This is an important development since, while it is often assumed that the use of performance-contingent elements in aggregate pay serves to increase risk taking by eligible executives, newer evidence suggests the contrary may be true with the use of ESOs often increasing the risk aversion of CEOs. They conclude, however, that the cases for and against UK executive pay packages remain unproven. While there is some evidence that sensitivity between total share return and executive rewards has been found, this sensitivity only explains a small proportion of total pay variance. Innovations like LTIPs, designed to increase this sensitivity, do not seem to have made a spectacular improvement, and firm size remains a more significant influence on executive pay, lending support to the further tightening of the regulation of executive pay in the UK. They observe that while there has been a focus on ESOs, LTIPs, severance payments, perquisites and salary, a neglected aspect of remuneration relates to short-term bonuses which are subject to weak disclosure requirements and possibly abuse. They also note that despite the extensive empirical evidence on executive remuneration, there remain gaps in our understanding of the complex issues of causality in the relationship between pay and performance. They also suggest that there is a need for greater understanding of the process of executive remuneration setting in terms of the relations between board representation, remuneration committee membership and nomination procedures for new directors.

Taking up this theme of the remuneration process, Bonet and Conyon (Chapter 7) examine the effectiveness of the primary corporate institution that determines executive compensation in US and UK publicly traded firms, that is, the compensation (or remuneration) committee. They document the structure and ubiquity of compensation committees in the population of UK publicly traded firms and show that most companies have remuneration committees, their size varies positively with market capitalisation, and that few companies have insiders on these committees. They then go on to examine whether poorly constituted compensation committees, as measured by insider membership of this committee, result in agency costs. Based on a panel data sample of about 500 publicly traded firms, their analysis indicates that executive compensation is higher when there is an insider (executive) present on the pay committee. Finally, their evaluation of prior academic research shows that self-interested behaviour and pay outcomes are more likely in the presence of poorly governed compensation committees. However, they note that the evidence is ambiguous. Some studies have failed to find evidence of higher agency problems in the presence of insiders in the remuneration committee. They suggest that the advice of compensation consultants to the remuneration committee may be particularly important in influencing the remuneration–performance relationship and warrants further investigation.

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Where internal governance does not adequately monitor the behaviour of managers, takeovers, and especially hostile bids, represent an important external governance mechanism whereby shareholders can replace underperforming or opportunistic managers. O'Sullivan and Wong (Chapter 8) review the evidence in relation to the underperformance of bid targets, the failure of takeover bids, the role of bid defences and the behaviour of target management in the context of takeovers, particularly concerning why managers resist some bids and accept others and the influence of internal governance characteristics on this decision. They find mixed and inconclusive evidence from both event and accounting studies regarding the link between preacquisition performance and takeovers is mirrored in respect of accounting studies. They also show that when takeover targets are categorised between hostile and friendly, no consistent performance differences are identified, suggesting that takeovers have a weak governance role. However, they point to recent research identifying higher rates of CEO turnover in takeover targets showing weak pre-bid performance provides some support for takeovers having a governance role. With respect to reaction to bids, evidence indicates that independent boards and active blockholders seek to ensure the maximisation of shareholder wealth in the takeover process. Initial hostility to bids falling short of forcing abandonment can be a means of increasing the bid price. When managers possess significant equity in the target company, takeovers are more likely to be friendly while managerial resistance is associated with low ownership levels, although high levels of managerial ownership may deter the disciplining of entrenched managers. O'Sullivan and Wong note that the significant decline in hostile takeovers since the mid-1990s may be the result of a general improvement in the internal governance of companies. O'Sullivan and Wong also find that from the perspective of shareholders in target companies, there is clear evidence of significant wealth gains arising from takeover bids. These gains appear to have been relatively consistent over the past three decades. There is emerging evidence that the size of shareholder gains may be greater where the takeover is financed by cash and where a bid is hostile especially in the presence of more independent boards. Boards resisting takeovers appear to possess a greater proportion of non-executive members and such resistance appears to result in greater bid premiums for shareholders. However, such board-oriented resistance does not impede the likelihood of bid success. The effects of takeovers on the shareholders of bidding companies have produced inconclusive results but the impact of specific bid characteristics suggest that the announcements effects of cash-financed bids and bids resisted by target management may be more positive. Research on the post-bid performance of bidders suggests that bids have a negative impact on the long-run performance of bidders. The majority of studies suggest that corporate efficiency does deteriorate in the years after the acquisition. The main conclusions regarding top management turnover is that rates of change after takeover are higher than either prior rates of turnover in targets or turnover levels in non-targets. There is some evidence that top management replacement is more likely subsequent to hostile bids. The abandonment of a bid typically results in a revaluation of the target by investors that may persist for many years after the abandonment with the long-term profitability of the targets improving. The successful defence of a takeover by management does not appear to guarantee management's own employment, the rate of management turnover in abandoned targets appearing to exceed what might be expected in non-targets prior to the bid. Consequently, it appears that such bids also have an important governance role.

Corporate governance issues have typically been focused on large firms with diffuse ownership. Filatotchev and Wright (2004) argue that they are also important for younger founder-managed firms, particularly for those reaching a point in their development when they begin to face constraints on their ability to realise growth opportunities. The agency-based corporate

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governance lens may be applied to these threshold firms since it is at this point that issues arise surrounding the pressures on founders to cede control if their firms are to grow. Yet, at the same time these firms need to find the resources and knowledge to enable them to grow. Corporate governance may thus need to be viewed as a dynamic system that may change as firms evolve over these stages. The firm's evolution is accompanied by changes in ownership structure, board composition, the degree of founder involvement etc. The balance of the accountability and enterprise roles of the various governance elements may change over this life-cycle from establishment, growth, maturity and decline. There is then a need to understand governance issues in firms that are more entrepreneurial.

Dalton *et al.* (Chapter 9) consider these issues and in particular focus on the intersection of governance and strategic leadership with firm performance. They find little evidence of a positive link between founders and firm financial performance, and also that research both on the link between founder characteristics and firm performance and on the difference between founders and non-founders is inconclusive. However, there appears to be a strong relationship between founders' strategic decisions and performance. Duality among publicly traded entrepreneurial firms tends not to be related to firm performance but establishing an effectively functioning top management team is critical to the success of an entrepreneurial firm. Boards of directors may also have an important role to play in entrepreneurial firms, where the founder is likely to be dominant and where there may be benefits from external oversight provided by an independently structured board. Studies have yielded inconsistent findings but do suggest that board of director composition and size are important for firm financial performance and that board composition is associated with the market's response at the time of an IPO. Dalton *et al.* also note that studies of venture-backed firms do indicate that venture capitalists add value, yet how much and at what price remains to be determined.

This last issue provides a link to the focus of the chapter by Wright, Thompson and Burrows (Chapter 10) which examines the contribution of the mechanisms involved in venture capital investments and leveraged management buy-outs to dealing with corporate governance problems in a wide variety of enterprise types. Both venture capitalists and leveraged and management buy-out financiers represent developments in capital markets that address the governance problems encountered therein. Both involve relationship investment with management, managerial compensation oriented towards equity and likely severe penalties for underperformance. The principal differences between them concern the nature of the relationship between investor and investee and that in investments by buy-out financiers most of the funding required to finance an acquisition is through debt. Investments by venture capitalists, which may also involve buy-outs as well as start-ups and development capital, make greater use of equity and quasi-equity. These differing relationships and financing instruments may be used to perform similar functions in different types of enterprise, so widening the applicability of the active investor concept within the Anglo-American system of corporate governance. Wright *et al.* review the evidence relating to the effects of buy-outs and venture capital investment and show that such changes in the ownership and financial structure may yield large gains in shareholder value and operating performance, but that both pre- and post-transactional governance problems also need to be addressed. They also suggest that the governance issues raised by buy-outs and venture capital investments have implications for the general corporate governance debate. First, they identify a need for a flexible approach to governance under which the forms adopted take account of specific factors such as the firm's product market and life-cycle circumstances. This approach recognises a role for enhanced voice, even in the context of exit-dominated capital markets. Second, their review of evidence relating to the monitoring problems of active

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investors suggests that even in cases where they have a major incentive to exercise voice, their ability to do so may be constrained by both access to information, the nature of the relationship with the management of the firm being monitored and the effort–cost–reward trade-off involved in close involvement. Third, it is clear from the evidence on the longevity of both buy-out and venture capital investments that governance structures are not necessarily fixed over time. As enterprises develop they may need to change their governance structure if value for shareholders is to be optimised.

There is growing recognition that corporate governance may vary between countries. Roe (Chapter 11) provides the first of two chapters considering international differences by examining the importance of corporate law, and in particular its ability to protect minority shareholders, in building securities markets and separating corporate ownership and control. Roe concludes that studies that examine corporate law worldwide tend to overpredict its importance in the world's richest nations. In these countries, where contract can usually be enforced, it is typically feasible to develop satisfactory corporate law. In such cases, if ownership and control have still not separated widely, Roe suggests that other institutional arrangements (such as product competition, tax laws, incentive compensation etc.) probably explain the situation. These other institutional arrangements may mean that there are high managerial agency costs of ownership and control being separated, such as relatively weak product market competition and relatively stronger political pressures on managers to disfavour shareholders. Roe also points out that there is too much that is critical to ownership separation that corporate law does not seek to reach. With respect to transition and emerging economies, there is the possibility that development agencies and governments may do what is necessary to get the corporate law institutions ready for ownership separation but the potential problem is that 'no one comes to the party'.

Denis and McConnell (Chapter 12) survey two generations of research on corporate governance systems outside the US. They show that the first generation of international corporate governance research is patterned after the US research that precedes it, with studies examining individual governance mechanisms, notably board composition and equity ownership, in individual countries. This research tended to focus on Germany, Japan and the UK and identified, even across these three very developed countries, significant differences in ownership and board structure. Of particular note in this first generation research is that ownership concentration in virtually every other country in the world is higher than it is in the US and the UK. They also find that in many countries, major shareholders' control rights exceed their cashflow rights. Importantly, they observe that the realities of ownership and control are such that the primary agency conflict in the US is relatively unimportant in many other countries. Rather, there is a different agency conflict between controlling shareholders and minority shareholders. The second generation of international corporate governance research considers the possible impact of different legal systems on the structure and effectiveness of corporate governance and compares systems across countries. This research shows that the extent to which a country protects investor rights has a fundamental effect on the structure of markets in a country, on the governance systems adopted and on the effectiveness of those systems. Strong legal protection for shareholders, they note, appears to be a necessary condition for diffuse equity investment. In countries with weak protection, it appears that only ownership concentration can overcome the lack of protection.

The German corporate governance regime is characterised by the existence of a market for partial corporate control, large shareholders, cross-holdings and bank/creditor monitoring, a two-tier (management and supervisory) board with codetermination between shareholders and employees on the supervisory board, a non-negligible sensitivity of managerial compensation to performance, competitive product markets, and corporate governance regulations largely

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based on EU directives but with deep roots in the German legal doctrine. Another important feature of the German regime is the efficiency criterion that corporate governance is to uphold. In Germany, in contrast to the Anglo-American system, the definition of corporate governance explicitly mentions stakeholder value maximisation. Goergen, Manjon and Renneboog (Chapter 13) provide an overview of the German corporate governance system. They describe the main theoretical models regarding the various alternative mechanisms and summarise the relevant empirical evidence on Germany. They also compare Germany to other countries to illustrate the peculiarities of the German case. They discuss the governance role of large shareholders, creditors, the product market and the supervisory board of directors. Furthermore, they focus on the importance of mergers and acquisitions, the market in block trades, and the lack of a hostile takeover market. Given that Germany is often referred to as a bank-based economy, particular attention is paid to the role of the universal banks. Voting control in Germany has often been eroded by ownership pyramids, the issue of non-voting shares, the application of voting restrictions (recently abolished) and the issue of multiple voting rights (recently abolished). Proxy voting also gives the banks' voice a disproportional vote on the general meetings. They show that the relationship between ownership or control concentration and profitability has changed over time, becoming negative in the 1990s. While the authors show that there is no clear evidence that banks play a positive monitoring role in German firms, their positive contribution is less ambiguous in financially distressed or poorly performing companies. This can be attributed to the banks' importance as creditors. The long-term lending relationships give banks considerable power, which is frequently strengthened by bank representation on the supervisory board of the firm. The authors also conclude that there is little evidence that the German codetermination system leads to superior corporate governance. Although there is a positive sensitivity of managerial pay to performance in Germany, the size effect (positive) dominates the compensation equation. Importantly, the pay-for-performance relation is influenced by large shareholder control: in firms with controlling blockholders, the CEO receives lower total compensation (compared to widely held firms) and the pay-for-performance relation is no longer statistically significant. When a universal bank is simultaneously an equity-holder and provider of loans, the pay-for-performance relation is lower than in widely held firms or blockholder-controlled firms. They show that the market for corporate control in Germany is very limited as the vast majority of firms have a large controlling shareholder and because pyramiding (with multiple layers of financial holdings sandwiched between the ultimate investor and the target firm) and cross-holdings hinder takeover attempts. Takeover regulations have created further barriers by facilitating court action by dissenting shareholders, board entrenchment, proxy voting, voting restrictions, multiple votes and non-voting shares. They do, however, note that since 1995 several regulatory initiatives have increased transparency and accountability such as the removal of powers of minority shareholders to stall restructuring and of voting restrictions and multiple voting shares.

Like Germany, the Japanese corporate governance system has also been characterised by the important role played by the banks. Japanese banks are allowed to maintain equity holdings of up to 5% in firms, a majority of which are also their clients. These bank equity holdings of client firms tend to be fairly stable over the years, with the intent to foster long-term client relationships. While close bank-firm relationships have been widely credited as being influential in increasing corporate governance efficiency and the development of long-term investment horizons, and a major global presence of Japanese firms, this has been called into question in recent years as the Japanese economic miracle came to a halt. In the light of this questioning of the bank-client relationship as the basis for an efficient corporate governance system, Wan

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et al. (Chapter 14) offer a different perspective to understanding Japan's banking industry. This perspective recognises the complex, rich, social relationships that define Japan's bank-centred systems. They view these bank-centred systems as social exchange governance networks, focusing on embedded social elements such as roles, power, reciprocity, expectations, and obligations. The explicit incorporation of these social elements into network structures allows them to uncover the underlying, complex relationships among exchange parties. They argue that while many network studies focus on the opportunities created by relational ties, network constraints may also reduce firms' flexibility or responsiveness. Banks in Japan, in addition to being lenders, may implicitly serve as 'insurers' for their affiliated firms against bankruptcy. To the extent that banking networks in Japan have heterogeneous characteristics, they propose that banks' strategic actions and hence performance are likely to vary in accordance with network characteristics. When the Japanese economy is growing, banks benefit substantially by facilitating network members in business expansion, in turn boosting banks' incomes. When the Japanese economy is contracting, some banks may be tightly constrained by their network ties and thus are unable to pressure their network members for restructuring because the banks are expected to fulfil their social obligation as *insurers* and stand behind financially distressed network members. As such, bank performance would be negatively affected in the contracting economy. The authors argue that Japan's almost sole reliance on bank-centred governance is a dangerous path since it is difficult to maintain efficient corporate monitoring and governance where board members have extensive interests tied with other member firms, an external market for corporate control is virtually non-existent, or where overdominance by one type of owner (that is to say, the bank) exists. In this regard, governance reform such as more independent directors or the development of an active external market for corporate control would be necessary. However, given that close bank-client relationships have spread and persisted as a result of historical, institutional, and social factors, regulatory changes alone may not be sufficient to induce banks and firms to abandon time-honoured practices and adopt new ones instead.

An important aspect of the debate about appropriate governance systems concerns the question of whether insider governance systems such as those found in much of Continental Europe, can survive in an environment of increasing pressure from financial markets dominated by outsiders, portfolio investors and without strong links with enterprises. Mary O'Sullivan (Chapter 15) examines these issues in the context of changes in corporate governance in France. First, O'Sullivan examines changes in the ownership structures of French corporations over the last quarter of a century. The notable changes identified are a decline in the ownership role of the state, the subsequent creation and unwinding of cross-shareholdings and the increased importance of foreign ownership of listed corporations, and an important continuity of family ownership. Second, O'Sullivan analyses the interaction between French corporations and the financial system, finding evidence of a decline in the financing role of the state, a major increase in reliance on equity issues as a source of external finance together with an increase in market as opposed to intermediate debt. These changes have been associated with developments in the distribution of corporate control. However, while corporate control remained firmly in the hands of insiders, they have exercised that control differently by pursuing strategies to expand internationally. O'Sullivan takes the view that a shift from insider to outsider control is only likely to occur under specific conditions confined to a small number of cases. Importantly, she argues that ownership structure does not make a major contribution to explaining recent developments in French corporate governance. Rather, she takes the view that other structural characteristics may also be important, such as industrial structure and the exaggerated hierarchies of French corporations that accord great power to the PDG (President

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Directeur General) and the networks that closely link these top managers. These arguments support those of Roe in Chapter 11.

Liu and Sun examine in Chapter 16 the situation of corporate governance in China. The changing aspect of governance in China is clearly an important topic given China's continued growth into one of the world's major economies and its perceived move from state to public ownership. This chapter examines the performance impacts and evolution of ownership and control mechanisms in Chinese publicly traded companies. After describing the institutional environment of China's state-dominated capital market and corporate governance system, Liu and Sun present research findings on the ultimate and intermediate control of Chinese companies, and the evolution of these ownership structures over the past decade. From a series of nested performance comparisons across three pairs of ownership – state direct control versus state indirect control, investment holding company versus industrial firms, and diversified business groups versus specialised companies – they find that the least inefficient intermediate control agent is the diversified industrial conglomerate in the indirect state control chain. In terms of the evolution of governance in China, Liu and Sun conclude that though the ownership of companies has changed, control, largely, still lies with the state through the use of pyramid structures. They argue more research is needed to understand a stylised fact in China: the least profitable firms are given top priority for privatisation, while the state keeps a firm grip on the most profitable companies.

Corporate governance in transition economies is distinguished from the economies of the west by the initial complete absence of the necessary prerequisites of an appropriate legal infrastructure and financial institutions in an environment where incumbent management and employees have entrenched rights within enterprises. The governance problem in transition economies focuses on identifying how one might move towards a structure that will better enable efficiency benefits to be delivered. Wright, Buck and Filatotchev (Chapter 17) discuss the nature of governance problems in transition economies and analyse the potential for the various elements of a corporate governance framework to resolve these difficulties. They outline the nature of corporate governance in the various types of approaches to privatisation adopted in transition economies and examine the role of and evidence relating to the various parties available in principle to undertake corporate governance. A common feature of transition economies is that after privatisation there is a decline in employee share ownership and a corresponding increase in managements' and outside investors' stakes. Increases in management equity holding may have some positive impact on corporate governance, especially if managers have to borrow to fund the purchase of shares and are constrained to improve performance in order to be able to repay loans. There remains a need for the state to create an adequate regulatory environment, to ensure that the newly established relations between recently privatised companies, financial and non-financial stakeholders and lending institutions will ensure economic efficiency improvements and promote corporate restructuring and technological modernisation. In the underdeveloped market systems found in transition economies, and the barriers to developing institutional voice mechanisms, it may be as important to emphasise measures to enhance entrepreneurial skills as it is to develop good governance systems.

NOTES

1. At the time of writing (July 2004) Google lists some 3.3m entries under the heading 'corporate governance'.

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2. Speech to the Conference on Bank Structure and Competition, Chicago, 8 May 2003.
3. Holmstrom and Kaplan (2003) argue that contemporaries have exaggerated the negative spillovers from these US corporate governance failings. They argue that in the long run, defined so as to include the events of Enron etc., returns on US stocks still exceed those in almost all other economies, suggesting the systemic damage is not too severe.
4. See Shleifer (1997).
5. These perspectives are explored in more detail in Blair (1995) and reviewed in Keasey *et al.* (1997), Chapter 1.
6. Margaret Blair (1995) provides a hypothetical example from Germany. Here she suggests that expectations of lifelong employment, underpinned by employee participation in governance, encouraged workers and employees alike to invest in specific human capital to a greater extent than would be feasible in the US or UK, with productivity benefits over the long term.
7. See Hughes (1993) for a review of the evidence and a somewhat pessimistic assessment of the effectiveness of the takeover sanction.
8. The short-termist critique is explored in more detail in Keasey *et al.* (1997), Chapter 1, and by Blair (1995). Tests of the critique typically involve the assessment of share price reactions to new events to determine whether the market overdiscounts long-term gains (for example, from R&D or capital investment spending announcements) relative to those with an immediate effect. The results typically reject short-termism (for example, Chan *et al.*, 1990), but this research is predicated on a semi-strong form efficiency assumption that proponents of the short-termist view would generally reject.
9. This is discussed in Thompson (2004).
10. Murphy (1999) provides a comprehensive review of the incentive aspects of executive stock options together with a discussion of their advantages and disadvantages as elements of a remuneration package.
11. The Act is discussed in Demski (2003).
12. The GlaxoSmithKline report of 2003 was rejected at the AGM following intense criticisms of the generous termination provisions being offered to CEO Jean-Paul Garnier (see Thompson, 2004). A substantial number of remuneration committee reports have attracted votes against of over 20%: see Chambers (2003), p. 809.
13. See Darrel E. Whitten: 'Japanese Corporate Governance: Buzzwords are not Enough', RIETI, 6 February 2003, at: www.rieti.go.jp/en/miyakodayori/060.html.
14. Dr Ulrich Siebert, Federal Ministry of Justice: 'Control and Transparency in Business (KonTraG): Corporate Governance Reform in Germany', at: www.Burkardlaw.com/corporategovernance/.

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