The Hampel Report on Corporate Governance

[Published in (1998) 16 *Company and Securities Law Journal* 408-413]

by G P Stapledon
Centre for Corporate Law and Securities Regulation, The University of Melbourne

Introduction

The corporate governance debate remains high on the agenda in the UK. In January this year, the Committee on Corporate Governance (Hampel Committee) released its *Final Report* (Gee Publishing Ltd, London, 1998). For the most part, the Report covers ground similar to that dealt with by, and endorses the approach of, its predecessors – the Committee on the Financial Aspects of Corporate Governance (Cadbury Committee) and the Study Group on Directors' Remuneration (Greenbury Committee).

The Committee

The Committee was chaired by Sir Ronald Hampel, the chairman (and formerly the chief executive) of ICI plc. The other members of the Committee included:

- four other chairmen of listed UK companies (two of whom resigned from the committee before its work was completed; one to become a minister in the Blair government, and the other to chair the Blair government's Better Regulation Task Force);
- the chief executive of a listed UK company;
- the finance director of a listed UK company;
- a lawyer;
- an accountant;
- an actuary;
- a fund manager; and
- a stock broker.

Like the Cadbury Committee and the Greenbury Committee, the Hampel Committee was sponsored by a cross-section of the British commercial sector. The sponsors were:

- London Stock Exchange;
- Confederation of British Industry;
- Institute of Directors;
- Consultative Committee of Accountancy Bodies;
- National Association of Pension Funds (NAPF); and
- Association of British Insurers (ABI).

The last two bodies are the main institutional investor representative organisations in Britain.

The Committee's remit

The Committee was asked to confine its review to listed companies. At a general level, the Committee's remit was to "promote high standards of corporate governance in the interests of investor protection and in order to preserve and enhance the standing of companies listed on the [London] Stock Exchange" (Report, p 66). There is, of course, to some extent a trade-off between protecting investors and minimising regulation. Indeed, the rationale of Australia's Corporate Law Economic Reform Program (CLERP) is that regulation is not costless. Reflecting this, the Hampel Committee's remit required the Committee always to "keep in mind the need to restrict the regulatory burden on companies" (p 66).

Specifically, the Committee was requested to:

- review the operation of the Cadbury Committee's *Code of Best Practice* (Gee and Co Ltd, London, 1992) (Cadbury Code), and make recommendations for changes if necessary;
- "keep under review" the role of executive and non-executive directors;
- pursue any matters arising from the Greenbury Committee's *Report* (Gee Publishing Ltd, London, 1995) (Greenbury Report) and *Code of Best Practice* (Gee Publishing Ltd, London, 1995) (Greenbury Code);
- address the role of shareholders in corporate governance;
- address the role of auditors in corporate governance; and
- deal with any other relevant matters.

The Committee apparently took a broad view of its remit – with Sir Ronald Hampel stating from the outset that the Committee would be engaging in a wide-ranging study of corporate governance, and not taking anything for granted (W Lewis, "Guide to the Great 'Untouchables' – Sir Ronald Hampel wants Wide-ranging Talks on the Issues of Governance", *Financial Times*, 11 March 1996, p 12). Sir Ronald indicated, for example, that the Committee would examine the merits of the German two-tier board structure – which involves a management board made up of senior executives and a separate supervisory board made up of non-executives, including employee representatives. The end result of the review is, however, a report which sticks closely to the ground well-trodden by the Cadbury Committee and the Greenbury Committee (and other review bodies, like the Working Group chaired by Henry Bosch AO (Bosch Committee): *Corporate Practices and Conduct* (3rd ed, FT Pitman Publishing, Melbourne, 1995)). On the issue of board structure, for instance, the Report simply points out that the Committee found overwhelming support for the unitary board (para 3.12); there is no analysis of the relative merits of the unitary and two-tier board structures.

Review of Cadbury and Greenbury Codes

The Committee thought it was too soon to reach a considered assessment of the impact of the Cadbury and Greenbury Codes (paras 1.8, 1.9). However, the Committee was concerned that shareholders and their advisers (presumably a reference to fund managers and institutional investor advisory organisations) had interpreted the Codes too rigidly. Submissions from the corporate sector complained that a "box-ticking" approach had been adopted by many investors, with insufficient account being taken "of the diversity of circumstances and experience among companies, and within the same company over time" (para 1.13). This complaint relates to the London Stock Exchange listing requirement that

companies must state whether they have complied with each guideline in the Cadbury Code and the Greenbury Code and, if not, why not (LR 12.43(j), (w), (x)). The Committee's view was

> "that there can be guidelines which will be appropriate in most cases; but that there will be valid reasons for exceptions. Where practices are approved by the board after due consideration, it is not conducive to good corporate governance for the company's explanations to be rejected out of hand and for its reputation to suffer as a result." (Para 1.13.)

These complaints from the UK corporate sector are reminiscent of the ASX's approach to disclosure of corporate governance practices. The ASX adopted Listing Rule 4.10.3 – which simply requires listed companies to describe what corporate governance practices they had in place during the reporting period; it does not recommend any particular practices – because:

- it was not convinced that best practice in corporate governance can be defined;
- it was not convinced that a company saying "Yes, we did A, B, C through Z" necessarily conveys useful information;
- it queried whether it is appropriate for a committee, or a stock exchange, to substitute its judgment for the judgment of elected directors;
- it was concerned that "prescription" might actually discourage development of best practice, by elevating compliance above innovation; and
- it was concerned that the ticking or non-ticking of a compliance box might lead to investors being misled as to the actual behaviour of the company.

(M L Newman, "Corporate Governance – the Australian Way" (paper presented to the Chartered Institute of Company Secretaries in Australia Ltd, 12 March 1996.)

The approach adopted by the ASX appears to represent a balance between, on the one hand, the ASX's desire to take a leadership role in helping to promote corporate governance standards for listed Australian companies (ASX, *Disclosure of Corporate Governance Practices by Listed Companies* (Discussion Paper, September 1994), para 2); and, on the other hand, the ASX's belief that it should not, as a general rule, regulate the internal functioning or structure of listed companies (ibid, paras 10-11; ASX, *The Role of the Australian Stock Exchange and its Listing Rules* (Discussion Paper, October 1990)). Given that the Hampel Committee (like the Cadbury Committee and the Greenbury Committee) was composed of representatives from across the corporate, investment and advisory sectors, it did not share the ASX's reluctance to set out benchmark practices. In addition, the Hampel Committee took a more accommodating view than the ASX of the purpose of specifying benchmark practices:

> "The objective of [a code of good practice] is not to prescribe corporate behaviour in detail but to secure sufficient disclosure so that investors and others can assess companies' performance and governance practice and respond in an informed way." (Para 1.25.)

The future: a set of principles and a combined code

In the Report, the Committee indicated its intention to produce a document containing (i) a set of principles of corporate governance, and (ii) a code of good corporate governance

practice – consisting of a combination of the Cadbury and Greenbury Codes (revised in some areas) and some Hampel Committee recommendations. The intention is that the current listing rules, which require listed UK companies to confirm their compliance with – and explain any non-conformance with – the Cadbury and Greenbury Codes, will be replaced by a rule requiring companies to disclose how they:

- apply the principles of corporate governance; and
- comply with the combined code (including a requirement to justify any significant variances) (paras 1.22-1.27).

At the time of writing, the London Stock Exchange was about to release revised listing rules incorporating the principles and (what has now been dubbed) the "supercode".

The Committee's principles of corporate governance

Under the proposed new listing rule, companies will be required to include a narrative statement of how they apply a set of principles of corporate governance. The principles set out in the Report are:

A *Directors*

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

II Chairman and Chief Executive Officer. There are two key tasks at the top of every public company – the running of the board and the executive responsibility for the running of the company's business. A decision to combine these roles in one individual should be publicly explained.

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

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

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

VI Re-election. All directors should be required to submit themselves for re-election at regular intervals and at least every three years.

B *Directors' Remuneration*

I The Level and Make-up of Remuneration. Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully. The component parts of remuneration should be structured so as to link rewards to corporate and individual performance.

II Procedure. Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual executive directors.

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

C *Shareholders*

I Shareholder Voting. Institutional shareholders have a responsibility to make considered use of their votes.

II Dialogue between Companies and Investors. Companies and institutional shareholders should each be ready, where practicable, to enter into a dialogue based on the mutual understanding of objectives.

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

IV The AGM. Companies should use the AGM to communicate with private investors and encourage their participation.

D *Acountability and Audit*

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

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

III Relationship with the Auditors. The board should establish formal and transparent arrangements for maintaining an appropriate relationship with the company's auditors.

IV External Auditors. The external auditors should independently report to shareholders in accordance with statutory and professional requirements and independently assure the board on the discharge of its responsibilities under D.I and D.II above in accordance with professional guidance.

Points of departure from Cadbury and Greenbury

The Hampel Committee endorsed the bulk of the Cadbury and Greenbury Committees' recommendations and Codes. However, in some areas it took a firmer stance

than the Cadbury Committee, and it departed from the approach of the Greenbury Committee in one respect.

Nomination committees

The Cadbury Code states that "Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for *the board as a whole*" (para 2.4) (emphasis added). The Cadbury Committee saw the use of a nomination committee – consisting of a majority of non-executive directors and charged with making recommendations to the full board – as "good practice", but only "one approach" to making board appointments (Cadbury Report, paras 4.15, 4.30). The Hampel Committee has gone further and suggested that the use of a nomination committee should be accepted as best practice – but with the proviso that smaller boards may prefer to fulfil the function themselves (paras 2.7, 3.19).

In Australia, the guidelines of both the Bosch Committee and the Australian Investment Managers' Association (AIMA) (which is now part of the Investment and Financial Services Association) recommend the use of a nomination committee (Bosch Committee, *Corporate Practices and Conduct* (3rd ed, FT Pitman Publishing, Melbourne, 1995), p 22; AIMA, *Corporate Governance: A Guide for Investment Managers and Corporations* (2nd ed, AIMA, Sydney, 1997), para 3.5). Interestingly, however, nomination committees have been adopted more widely among large listed UK companies than among their Australian counterparts. In 1994, 69 per cent of the Top 100 listed UK companies had a nomination committee, compared to only 19% of the Top 100 listed Australian companies a year later (G P Stapledon and J J Lawrence, "Board Composition, Structure and Independence in Australia's Largest Listed Companies" (1997) 21 MULR 150 at 176).

A "lead" non-executive director

The Cadbury Committee was innovative in its recommendation that, where the roles of chairman and chief executive are combined, there should be a strong and independent element on the board, with a recognised senior member (Cadbury Code, para 1.2). The Hampel Committee has taken this point one step further. The Report recommends that a senior *independent* non-executive director should be identified in the annual report – for those occasions "when there is a need to convey concerns to the board other than through the chairman or chief executive officer" (para 3.18). (As to who would be conveying concerns to the board, presumably the Committee had shareholders in mind.)

This recommendation may be a reaction to the increase in the number of large listed UK companies which have an *executive* chairman and a separate chief executive (see G P Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford University Press, Oxford, 1996), pp 71-73 (this structure existed in only 17 per cent of the Top 100 companies in 1971, but it had increased to 39 per cent by 1991)). The practice of having an executive chairman and a separate chief executive grew in popularity in Britain after a push for a separation of the roles of chairman and chief executive by institutional investors during the 1980s and early 1990s (ibid, p 67). The irony is, of course, that the push for a separation of

the two roles was based on an assumption that the "separate" chairman would be a non-executive director and therefore able to play a truly effective role as leader of the board of directors, without the concern of wearing another (executive) hat (Sir Adrian Cadbury, *The Company Chairman* (Director Books, Cambridge, 1990), p 114).

Executive directors

The Hampel Committee reiterated the point made in the Cadbury Report (para 4.3) that the board as a whole must take overall responsibility for the leadership and control of the company (Hampel Report, para 3.6). The Committee then focused on executive directors other than the chief executive (for example, the finance director). The issue of concern stems from the fact that an executive director wears two hats – one as a subordinate of the chief executive and the other as an "equal" member of the board of directors. The Committee's view is that:

> "As well as speaking for the business area or function for which he or she is directly responsible, an executive director should exercise individual judgement on every issue coming to the board, in the overall interests of the company. In particular, an executive director other than the chief executive officer needs to be able to express views to the board which are different from those of the chief executive officer and be confident that, provided that this is done in a considered way, the individual will not suffer. Boards should only appoint as directors executives whom they judge to be able to contribute in these ways. Board appointment should not be regarded simply as a reward for good performance in an executive role." (Ibid.)

Some might say that this is wishful thinking. Interestingly, Henry Bosch AO was reported recently as predicting that by 2010 the board of a typical listed Australian company would have only one executive member – the chief executive (C Bolt, "Patrick's Board did its Duty: Henry Bosch", *Australian Financial Review*, 26 May 1998, p 10).

Identification of independent directors

The Cadbury Committee recommended that a majority of each listed company's non-executive directors should be "independent" – that is, independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement (Cadbury Code, para 2.2). This recommendation was endorsed by the Hampel Committee. But the impact of a recommendation that a majority of the non-executive directors should be independent depends, in the first instance, on the recommended proportion of non-executive to executive directors. The Cadbury Committee recommended a minimum of three non-executives (Cadbury Report, para 4.11) and the Hampel Committee expressed the view that it would be difficult for non-executives to be effective if they made up less than one-third of the board (para 3.14). Clearly, the ultimate recommendation on independent directors falls far short of that put forward in Australia by AIMA (AIMA, *Corporate Governance: A Guide for Investment Managers and Corporations* (2nd ed, AIMA, Sydney, 1997), para 3.2 (recommendation that a majority of board members should be independent non-executives)).

The Cadbury Committee did not state expressly that independent directors should be identified in the annual report, but it probably implied as much in suggesting that information about "the relevant interests" of directors should be disclosed in the directors' report (Cadbury Report, para 4.12). The Hampel Report clarified the matter: "boards should disclose in the annual report which of the directors are considered to be independent and be prepared to justify their view if challenged" (para 3.9).

Re-election of directors

The Cadbury Report proceeded on the ill-founded assumption that directors of UK companies are always subject to periodic endorsement by the shareholders (G P Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford University Press, Oxford, 1996), p 68, n 82). The true position is that, as in Australia, the standard Table A articles in the UK expressly exclude executive directors from the general requirement to retire by rotation, and submit for re-election by shareholders, once every three years (Companies (Tables A to F) Regulations 1985 (SI 1985/805) (UK), Table A, art 84; *Corporations Law*, Sch 1, Table A, reg 79(2); ASX Listing Rule 14.4 now permits only one "managing director" to be insulated from the requirement to submit for re-election by shareholders at least every three years).

The Hampel Committee agreed strongly with the two key UK institutional investor peak bodies – the NAPF and the ABI – that re-election by shareholders at least every three years should be a requirement for all directors. This is reflected in Principle A.6, set out above.

The remuneration committee

The Greenbury Committee recommended not only that the board of each listed company should establish a remuneration committee of independent non-executive directors (Greenbury Report, paras 4.6, 4.8), but also that the remuneration committee should have "a special responsibility to discharge, on behalf of the board, certain functions which the board itself should not discharge" (ibid, para 4.7). The Hampel Committee agreed that the remuneration committee should determine the compensation packages of executive directors, but it did not agree that overall remuneration policy should be delegated to the remuneration committee: "the establishment of the broad framework of executive remuneration and its cost is in our view a matter for the full board, *on the advice of the remuneration committee*" (para 4.12; emphasis added).