

CORPORATE GOVERNANCE

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FIRST MAILING

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ADDITIONAL TEXTBOOK: Corporate Governance Principles Policies & Practices (2009) by Bob Tricker

INTRODUCTION

Welcome to our first booklet for this distance learning course. We do hope you enjoy studying with us.

The purpose of this course is to prepare you for the ICSA Corporate Governance examination. Everything will be geared to this objective. However this is also a contemporary and controversial subject and we will include extra material to help deal with the current debate and provide that extra information to distinguish you in the Section B essay questions.

The examiners

Getting you ready for this exam requires a knowledge of the examiner and what the examiner wants. There have been three and you will be sitting the third examination of the third!

The first examiner was Joan Bingley, a practising company secretary who is the author of a book on Take Overs and Mergers and was the ICSA's principal advisor to the Law Reform Committee which produced the Companies Act 2006. She was a previous President of the ICSA as was her chief marker, Peter Hammonds. Joan Bingley retired as examiner in 2006.

June 2007 saw the first examination with the second examiner, Jill Solomon, who is a senior lecturer in Finance at Cardiff University. She had written a book "Corporate Governance and Accountability" which is now quite out of date regarding the Code. We will continue to include references to her text throughout the course.

The third examiner is Brian Coyle who is the author of the ICSA text "Corporate Governance" that you received as part of your enrolment fee. So the questions in your ICSA textbook should reflect the interests of your examiner. Although he set the 2009 examinations he also marked – but did not set the November 2008 examination.

There is a CD accompanying the course which contains all the past papers and examiner's reports from all the examiners together with selected source material published by the institutional investors. Please do refer to the CD throughout the course.

The textbook we include with this course.

To our delight the person who first coined the term "corporate governance" and is one of the leading lights in the subject has produced a book. His name is Bob Tricker and together with Adrian Cadbury he is an authority that no examiner can ignore. We will include references to this book and earlier works by Tricker.

The examination paper

The examination paper is split into Section A and Section B. The idea behind this is for Section A to ask short questions covering the whole syllabus and for Section B to require the more traditional in depth analysis. In practical terms the answers to Section A question can usually be found by looking up the terms in Brian Coyle's book.

At the back of this booklet are a series of questions. Do read them now and keep them in mind as you work through our material and read Coyle and Tricker's books. When you feel able to answer a question please do so and send to me for marking and return with a marking code.

The Correct Law

We will teach corporate governance according to the UK law at June 2010 (i.e. we have incorporated the Companies Act 2006 in its entirety).

This is enough introduction – let us get down to business.

THE CENTRAL THEMES IN CORPORATE GOVERNANCE

The phrase "Corporate Governance" is relatively recent. The first time the phrase 'corporate governance' appeared was in a book entitled "The Independent Director" written by Robert Tricker in 1976. He followed this with "Corporate Governance – practices, procedures and powers in British companies and their boards of directors" published in 1984. He repeated the phrase in an Economist book "Pocket Director – Essentials of Corporate Governance for A to Z". We include his latest book with this course.

However the themes covered by corporate governance are far from new. They are concerned with:

- a. The problems that arise when business becomes big.
- b. The problems of protecting the weak, vulnerable, greedy and gullible when they come into contact with big business.
- c. The problems that arise between the owners of big business and the people who run the big business.
- d. The problems that arise between the big business and other powers in the society.

Some examples will help illustrate Corporate Governance's pedigree.

Pepys and the Navy

In 1670 the Royal Navy was the UK's biggest industrial concern and the biggest employer in the country.

We know exactly how it was run because the man doing so wrote it down in a diary – Samuel Pepys. Edward Montagu, the Earl of Sandwich, got him the job of clerk of the acts with the Navy Board at a salary of £350 per year. "And if Pepys had little idea what was involved in terms of work and was not even sure whether he wanted to keep the job or trade in it, he began to find out at once that it was worth more than the salary as offers of money came in from people hoping to profit from his good fortune... the new position came to him solely through patronage, **making it an appointment of exactly the sort Pepys himself objected to later**" Claire Tomalin: "Pepys – the Unequalled Self".

"Pepys was tempted by another man who offered him £500 for the job and then as he hesitated doubled his offer to £1,000. **Lord Sandwich explained to him that it was not the salary that made a man rich but "the opportunities of getting money while he is in the place"**.... Indeed Pepys was quickly targeted by suppliers who saw him as a valuable ally. William Warren the biggest of the timber merchants with a house and yards in Essex, Rotherhithe and Wapping came to him with friendly offers of financial advice, backed by presents indistinguishable from bribes as Pepys was well aware; for example, a pair of gloves containing forty gold pieces..... **the Duke's instructions to the Navy Board urged complete disinterestedness but they were not taken too literally by anyone... The sums of money involved were huge.**

"In a supreme irony in 1677 Pepys made history at a stroke bringing about a revolution in the way the Navy was run. He proposed and succeeded in getting approved:

No one should be appointed as lieutenant until

- he had served for three years, and
- Received a certificate from his captain and
- Passed an examination in navigation and seamanship at the Navy Office...

Pepys's belief was that education and intelligence were more useful to the nation than family background and money; and that however gallant and courageous 'gentleman captains' might be the service needed to be professionalised."

"Pepys is often spoken of as an early civil servant but there was no civil service as we know it: no career structure, no examinations for entry, no clear path of promotion and no pension system... The members of the board were chosen by the King and whoever he chose to listen to... and this became clear in the political scandal of the Popish Plot in 1679. Charles II was forced to make concessions to Parliament, one of which was to relinquish control of the Admiralty. Pepys was falsely accused of treason and held for a time in the Tower of London. The new Admiralty Board appointed by

Parliament proved to be a disaster dissolving Pepys' organisation and ordering a new fleet of ships that it had no means of maintaining.

Charles' position was sufficiently restored by 1684 for him to dismiss the Admiralty Board and reappoint Pepys in the more powerful position of Secretary for the Affairs of the Admiralty. He reinstated many of the reforms from his first term in office and in 1686 established a special commission on the requirements of producing a modern fleet. Pepys' legacy to the Admiralty was primarily one of impartial service, as a civil servant would be expected to act today. He was determined to do his best for the service and as such was marked apart from many of his contemporaries who had wider political ambitions. He acted to root out corruption and improve discipline, training and conditions in the navy. Mind you he still accepted leather gloves...

Using the terms of today's corporate governance, The Navy Board was grappling with: ethics, accountability, the delegation of power to a chief executive, and above all, "appropriate remuneration".

The South Sea Bubble

The British government of 1711 had spent itself into debt totalling over ten million pounds. A large group of merchants joined together and bought some £9,000,000 of the debt, assured by the government of a six percent interest rate: £540,000 income guaranteed annually. They were the South Sea Trading Company. The British government gave them exclusive trading rights to four ports Spain was allegedly willing to open up in Chile and Peru. The South Sea Company was set up to import gold and other valuables from South America and finance them from the incoming interest from the government.

The news that was not heeded was, in hindsight, somewhat crucial: King Philip V of Spain let everybody involved know that he was only willing to let in one ship a year.

The South Sea Company started selling its shares on the market. Within months, the stock had soared from £100 to £1000, with no end in sight. The South-Sea Company made millions overnight, and in no time there were plenty of other trading companies popping up to take advantage of the speculative frenzy.

Investors bought rising stocks no matter how outrageous their design, anticipating lines of idiotic speculators to form behind them eager to gobble the stock at a higher price.

Most of the semi-legitimate businesses claimed to go gold-hunting in the New World, or some such silk or tobacco trading. However, plenty of the illegitimate ones didn't. Here's but a small sample of business propositions:

- For trading in hair.
- For insuring of horses.
- For improving the art of making soap.
- For improving of gardens.
- For insuring and increasing children's fortunes.
- For a wheel for perpetual motion.
- For paying pensions to widows and others, at a small discount.
- For making iron with pit coal.
- For the transmutation of quicksilver into a malleable fine metal.
- And the "all-time classic: For carrying on an undertaking of great advantage; but nobody to know what it is".

While the directors of the Company insisted profits were just around the corner, and even outbid the Bank of England for an additional £31,000,000 of government debt in 1719, one dreary day in September 1720 no one wanted to buy stocks. The bubble burst – the company ran out of cash. Nearly every family of any social standing had been caught by the economic storm. The next time you walk into the National Gallery in Trafalgar Square note the grand colonnade. It came from North London house of the Duke of Chandos which was pulled down and sold to pay off his South Sea

debts. For those who sold before the bubble burst life was good – a bookseller left £240,000 in his will to found a hospital which still bears his name – Thomas Guy.

The Government launched an investigation. The Committee of Secrecy discovered appallingly lax internal controls which had existed within the South Sea Company, stripping away the pretence that it was a great financial institution with a properly ordered set of accounts and financial system. It discovered there had been a share support scheme run by the directors through the company's brokers. The committee concluded that the company had grown far beyond the power of Parliament to control it. There were no financial checks and balances. "Relieved of their onerous burden, the country's rulers had surrendered themselves either to bribes or to the power of the market". Michael Balen – "A Very English Deceit". Parliament decided to prosecute the politicians on the board which included the Chancellor of the Exchequer. There were convictions and acquittals but the true winner was the Prime Minister – the first powerful British Prime Minister – Robert Walpole. The following year Parliament went after the assets of all the directors – one of whom, Hawes, had burnt his books! They were left ruined, as they had done to so many investors. Under Walpoles' hegemony... "the stock market sank back into the shadows corralled by new legislation against bubbles and activities of stock jobbers". Michael Balen.

Under the terms of today's corporate governance, we are talking: transparency; accountability, risk monitoring; regulation of the stock exchange.

The rise of the big firm

Adam Smith & the **Division of Labour**: "The greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity and judgement with which it is any where directed, or applied, seem to have been the effects of the division of labour.... To take an example, therefore, from a very trifling manufacture; but one in which the division of labour has been very often taken notice of, the trade of the pin-maker; **a workman not educated to this business (which the division of labour has rendered a distinct trade), nor acquainted with the use of the machinery employed in it (to the invention of which the same division of labour has probably given occasion), could scarce, perhaps, with his utmost industry, make one pin in a day, and certainly could not make twenty.** But in the way in which this business is now carried on, not only the whole work is a peculiar trade, but it is divided into a number of branches, of which the greater part are likewise peculiar trades. One man draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on, is a peculiar business, to whiten the pins is another; it is even a trade by itself to put them into the paper; and the important business of making a pin is, in this manner, divided into about eighteen distinct operations, which, in some manufactories, are all performed by distinct hands, though in others the same man will sometimes perform two or three of them. I have seen a small manufactory of this kind where ten men only were employed, and where some of them consequently performed two or three distinct operations. But though they were very poor, and therefore but indifferently accommodated with the necessary machinery, they could, when they exerted themselves, make among them about twelve pounds of pins in a day. There are in a pound upwards of four thousand pins of a middling size. **Those ten persons, therefore, could make among them upwards of forty-eight thousand pins in a day.** Each person, therefore, making a tenth part of forty-eight thousand pins, might be considered as making four thousand eight hundred pins in a day. But if they had all wrought separately and independently, and without any of them having been educated to this peculiar business, they certainly could not each of them have made twenty, perhaps not one pin in a day; that is certainly, not the two hundred and fortieth, perhaps not the four thousand eight hundredth part of what they are at present capable of performing, in consequence of a proper division and combination of their different operations." (For UK students – look at the back of the new £20 note)

The division of labour observed by Adam Smith became the scientific study of work by F.W.Taylor. Together with Henry Ford he invented the production line and mass production. Ford and Taylor offered the American Dream to all the world's unskilled if they could make it to Detroit. The wages were the best for unskilled work in the US, there was housing, medicine, community.

But the production line was not the end of company development. “During the first two decades of the twentieth century, managers at Standard Oil of New Jersey, Dupont, Sears Roebuck and General Motors invented a new way of organising and managing their businesses. Their creation – the now ubiquitous multidivisional form – involved fundamental changes in the design of the firm. While the most visible change was structuring the organisation on the basis of divisions defined by product or geography, rather than functionally, the new form also involved new systems for collecting and recording information, for allocating resources and for controlling behaviour. This new model permitted an efficient solution to the incredibly complicated problem of co-ordinating and motivating large numbers of people carrying out a complex of inter-related activities often in different locations. It thus allowed giant, multiproduct business organisations to emerge and function effectively on a continental and then global scale. The new design also led to a huge growth in the number of people working as managers and to the emergence of a set of values and norms that mark management as a profession”.

And the companies got bigger and more successful. The power of the US multinational was a sight to behold.

One of the period’s leading economists, J.K.Galbraith, talked of the “New Industrial Society” and wrote **“the corporation has ceased to be the instrument of the owner and his personality; the men now running such enterprises own no appreciable share and are not selected by the shareholders but narcissistically by the Board of Directors...** Power in economic life has passed from land and capital to that composite of knowledge and skills known as the technostructure... the goal that has a natural pre-eminence is the organisation’s own survival... A secure level of earnings and a maximum rate of growth consistent with the provision of revenues for the requisite investment are the prime goals of the technostructure. Technological virtuosity and a rising dividend rate are secondary in the sense that they must not interfere with the two first-mentioned objectives.”

It was so obvious. In the US the sit-coms all had company men as leads – look at “Bewitched”. In the UK The BBC could run sit-coms based on the company manager working his way to the top- “Terry and June”, “The Good Life”. I remember a school visit to the Ford Management Head Office. We were shown into a windowless room with a huge chart of names and lines on one side of the wall, like those puzzle mazes you see in paperbacks you attempt on holiday. The junior executive who was our host made his presentation with his line manager standing behind him ticking a clip board. The chart was the complete Ford management team. Where was our young man? He pointed to the bottom, not even through the first hurdle.

This was the “default career”

And then the revolution took place – not of the proletariat but of communication, information and data. Throughout the 1970s, 1980s and 1990s middle management succumbed to mortality like the millions in the influenza epidemic after the first world war.

And once the cult of destruction was under way not only middle managers but whole industries disappeared. Under the soil in the UK is enough coal to be self sufficient in energy for the next 400 years. We had the technology to extract the coal and to wash it so that it became clean. We closed the pits, sold the technology and place our faith in North Sea Gas. Now the gas is gone, and we are dependent on Time Magazine’s Man of Year Vladimir Putin not to turn off the Siberian tap. For me a trip to a coalmine was a visit to a business for my grandchildren it will be a heritage visit. Ask your relatives who they think it to blame... if anyone... I never had any intention of going down the pit!!

The UK is an island and at the beginning of the twentieth century built half the world’s ships – last year it built one – HMS Daring.

In 1994 Anthony Sampson could write a book: “Company Man: The Rise and **Fall** of Corporate Life.”

The governance terms we would use today are “accountability, stakeholder power, transparency”.

Who is in charge today is an interesting question.

The Political Questions

Beginning again with Adam Smith note that he wrote this about the owners:

“People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices and it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.”

At the other end of the century the American term “anti-trust” arose because the large American corporations used trusts to conceal the nature of their business arrangements. Big trusts became synonymous with big monopolies, the perceived threat to democracy and the free market these trusts represented led to the Sherman and Clayton Acts. These laws, in part, codified past American and English common law of restraints of trade. Senator Hoar, an author of the Sherman Act said in a debate, “We have affirmed the old doctrine of the common law in regard to all inter-state and international commercial transactions and have clothed the United States courts with authority to enforce that doctrine by injunction.” Evidence of the common law basis of the Sherman and Clayton acts is found in the Standard Oil case, where Chief Justice White explicitly linked the Sherman Act with the common law and sixteenth century English statutes on engrossing.

Moving on the workers in these organisations a study of the nineteenth century will quickly reveal the state of the poor, the rise of the unions, the attempts to expand education and suffrage. And of course Karl Marx who was right to say “ a spectre is haunting Europe, the spectre of communism”.

For most of the twentieth century there existed an alternative system of manufacture, an alternative way of organising production – Russian or Chinese communism.

Topics that mattered in the last thirty years of the twentieth century: neo-imperialism, neo-colonialism, independence, nationalisation of the means of production, are now consigned to the historical shelves but the politics of the large company, the politics of the multinational corporation and where its loyalty lies are still with us. I still remember an evening in 1973 and the indignity of following the General Manager of Phillips Zambia as we crawled under tables to escape a hail of bottles thrown at us when some Chinese acrobats unfurled a banner stating that “Running dogs of neo-capitalism should be punished.” The Chinese were building “non-aligned bridges” with Zambia, this was their show and the beer was free, the crowd was drunk and the front row were all invited from the leading multinationals in the country.... I was there because I knew the MD and he used his power to get me a ticket... we are back to Pepys again.

And over the last year it seems we are back to the South Sea Bubble too!!! The banking failure involving speculation in sub-prime mortgages, collateralised debt obligations and variations of the Scholes-Black options pricing model has taken place against a background of the Combined Code, Stock Market regulation and US legislation. It became so important that it featured as question in November 2009 (question 6).

To summarise this introduction, although what we are going to study may appear new, with strange terminology, even the invention of theories, it has a long history. Sometimes we are trying to stop fraud; sometimes we are trying to remove injustice; sometimes it is the conduit some believe will fundamentally change our world.