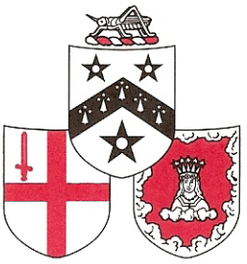

GRESHAM
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Gresham Special Lecture

THE FUTURE FOR GOVERNANCE: THE RULES OF THE GAME

delivered by

Sir Adrian Cadbury

at Mansion House

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Gresham College, Barnard's Inn Hall, Holborn, London EC1N 2HH

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'There is one and only one social responsibility of business - to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game...'

Milton Friedman

I was honoured to be asked to give this lecture and I am grateful to Gresham College for the opportunity to reflect on what I have learnt from my involvement in corporate governance since 1991, when I was asked to chair a committee on the subject. We delivered our Report and Code of Best Practice at the end of the following year and imagined that this would be the end of the matter and that we could retire to cultivating our gardens. This, however, was not to be, because by then corporate governance, which we had defined as 'the system by which companies are directed and controlled', had become a matter of considerable public interest worldwide. We disbanded as a committee in May 1995 after publishing an assessment of compliance with our Code of Best Practice. Since then I have continued to be involved through taking part in debates and conferences on corporate governance around the world. I aim to end this governance odyssey with my forthcoming visits to Spain and Chile, which is why this is an appropriate time for reflection.

Background

Governance is a word used by Chaucer, but not often heard until Harold Wilson took it up in reference to the governance of the country – a field from which I have managed to steer clear! It means either the action or manner of governing, or the method of management, and it is in that second sense that it is applied to companies or corporations. In Chaucer's time the word carried with it the connotation 'wise and responsible', which fits well with the theme of my talk.

Governance's Latin root means 'to steer' and an apt quotation from classical times is 'He that governs sits quietly at the stern and scarce is seen to stir'. The analogy of the quiet steersman sums up what I see as the right approach to governance – a light hand on the tiller, thanks to looking ahead and identifying in good time when a change of course is needed. But how does the steersman know what course to set and who it is that we expect to respond to his guidance?

Our Committee's Code of Best Practice was directed primarily to the boards of directors of quoted companies, although we said in our Report that we 'would encourage as many other companies as possible to aim at meeting its requirements'. It was an

addition to the complex set of forces which regulate corporate behaviour and less directly the conduct of those belonging to professional bodies. It is those forces which I propose to discuss in the light of the international debate on corporate governance in which I have taken part. I chose the title 'The Rules of the Game' because that is the issue. What are the rules, who sets them and do they matter?

I take as my text the quotation from an article by Professor Milton Friedman which heads this lecture. Milton Friedman is the arch-advocate of companies concentrating solely on maximising the return to their shareholders, but the important qualification which he puts on that aim, staying within the rules of the game, is too often omitted. He explains in the same article that, by the rules of the game, he means, 'while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom'. What are these rules embodied in law and in ethical custom to which corporate officials should conform?

The Governance Framework

A useful distinction is between externally imposed rules and internally imposed ones. Internal rules in turn break down into those which companies or professions set for themselves and those which we as individuals set for ourselves, our personal ethical values, or the rules by which we live.

Corporations work within a governance framework which is set first by the law and then by regulations emanating from the regulatory bodies to which they are subject. In addition, publicly quoted companies are subject to their shareholders in general meeting and all companies to the forces of public opinion. The influence of public opinion should not be underestimated; it compelled Shell to change its plans for the disposal of the Brent Star platform. Not only is public opinion a governance force, but it is one whose impact cannot be precisely foreseen in the same way as that of the law and regulations; it is not fixed in form as they are, but responds to the mood of the moment. The views of investors and public opinion reflect their current thinking, and boards of directors and members of professional bodies need to respond by being continually alert to the changing expectations of those whom they serve.

Clearly the balance between these governance forces varies between countries. Where the opinions of shareholders and of the public cannot make themselves sufficiently felt, the gap needs to be filled by the law and appropriate regulations. This is why each country has to devise its own governance framework. But how effective is this framework of governance? The legal rules are clear-cut and carry known penalties if boards of directors contravene them. Regulations are equally straightforward; if quoted companies do not abide by the rules of the London Stock Exchange, they risk de-listing.

When it comes to codes, such as the one drawn up by our Committee, there is not the same degree of external discipline. The recommendations of the Code of Best Practice were neither mandatory nor prescriptive. Boards were required to state in their annual report how far they complied with the Code and to give reasons for areas of non-compliance. Boards had to make a *compliance statement.* Compliance itself was left as a matter between boards and their shareholders. What made that requirement effective was that it had the authority of the London Stock Exchange behind it. Publication of a compliance statement became a condition of listing on the Stock Exchange and that backing was all-important.

The Committee considered that companies as a whole would see it as in their interest to comply. Compliance would publicly confirm that they met the standards expected of well-run businesses. The Code was literally based on best practice, on the way in which successful companies were directed and controlled. Meeting best practice has to be a logical aim for boards and we expect investors, especially the institutions, to encourage the companies in which they held shares to comply. In effect, the Committee was looking to market regulation, rather than strictly self-regulation, to win board acceptance for its recommendations. Provided investors, analysts and lenders valued compliance with the Code, it would confer a market advantage on companies which complied, possibly assisting their credit rating and lowering their costs of capital. In addition, good corporate governance is increasingly being linked to good corporate performance and so complying with the Code could be expected to add to a company's competitive edge. Indeed, my continuing involvement with corporate governance is founded on the positive contribution which I am convinced it can make to board effectiveness.

Similar codes around the world have equally relied on companies seeing it as in their best interest to comply. None is mandatory and most are backed by the appropriate Stock Exchange. In sum, I believe that such codes are effective, both in assisting boards to direct their companies well and in providing some insurance against fraud and failure, provided that they are based firmly on best practice, not on what best practice in the abstract might be thought to be, and that they have some market discipline behind them. Thus codes can usefully fill a layer below the law and regulations and help to clarify the rules of the game. But why not make compliance compulsory, on the argument that well-intentioned companies will no doubt follow the best practice lead in any case, but it is precisely the less well-intentioned who most need to be brought within the rules? There is clearly force in that argument. However, an important reason why I believe that there is a place for codes in establishing the rules of the game is that it is hard to frame legislation which will raise governance standards.

Regulatory Form

First, the focus has to be, not on the form of governance, but on its quality, for which legal tests are difficult to devise. The Code of Best Practice, for example, refers to the need for boards to include non-executive directors of sufficient calibre for their views to carry significant weight in the boards' decisions. A word like 'calibre' may have no legal standing, but it can certainly be recognised by investors and financial commentators. When a major UK company appointed its first batch of non-executive directors, they were seen as not measuring up to this requirement of the Code. Investor pressure and press comment resulted in the appointment of a further non-executive director of sufficient bottom.

To take another example, the Committee said in its report that in principle the chairman and chief executive should not be the same person. Being non-prescriptive, however, the Code did not make separation of the top two corporate posts a recommendation. If separation were to be a legal requirement, boards could circumvent it by giving two of their members different titles, while in reality power remained in one pair of hands. If shareholders queried the balance of power on such a board, the board could reply that they complied with the law and that there was no more to be said. The Code, however, requires that, 'There should be a clearly

accepted division of responsibilities at the head of a company...such that no one person has unfettered powers of decision'. Shareholders can demand to know precisely how powers are divided, and continue probing until they are satisfied. In that sense, a code recommendation can prove a sterner test in practice of a true separation of powers than a law to the same effect.

A further reason for backing statutory regulation with market regulation is that codes can reflect changing circumstances or new governance issues as they arise, whereas the law by its nature takes time to catch up with new situations. In the same way the law sets a floor to corporate or professional behaviour, whereas codes can promote best practice beyond lawful practice. The law is limited to the letter, while codes can put substance above form.

Disclosure

The foundation on which the Code of Best Practice and its equivalents elsewhere are based is that of disclosure. Disclosure is the lifeblood of governance. Provided those with interests in, or responsibilities towards, companies know how they are directed and controlled, they can influence their boards constructively. A leading bank responded to the Code by including a section in its Annual Report headed 'How our business is run'. This covered the role of the board, the work of its committees and the responsibilities of directors; information which had never previously been accessible. Investors, lenders, employees and the public can only play their governance roles provided they have the information they need in order to do so. Transparency is the aim. This requires clear reporting of the state of the business, of the way it is directed and controlled and of its place in the community. Openness by companies is the basis of public confidence in the corporate system. It also enables external governance forces to function as they should. Institutional investors, in particular, have the means and the incentive to use codes to promote board effectiveness. As to whether codes work, the degree to which the majority of quoted companies responded to the Code of Best Practice is evidence that codes can give a lead which will be followed, provided they genuinely represent best practice and thus are going with the grain of investor and corporate opinion.

City Rules

If the law, regulations, codes of best practice and the shareholders in general meeting (where appropriate) form the external rules of the game, what about the rules which companies and professionals draw up for themselves? Most professions, for example, have rules to which qualified entrants subscribe. On the corporate side, the natural example to take, given where we stand, is that offered by what might loosely be called 'The City', that is to say the financial services centred on London.

Looking back over the last century, the internal rules which the City set for itself could be said to be based on those of a London Club. They relied on peer pressure for their effectiveness. There was a generally accepted code of conduct, and those who transgressed it could find themselves expelled from the Club and debarred from taking further part in City activities. There are advantages to such Club rules. They carry no top-hamper of bureaucracy, the incentive to conform is strong and the penalties for flouting the rules are swift and condign. The growth of the City over the years is a tribute to their efficacy.

The danger with the Club rule approach to governance is that the members may come to put their own interests ahead of those who ultimately provide them with their livelihood. Clubs, whether of financiers or of members of professional bodies, have a tendency to close ranks against the outside world to protect their interests. The Steam Loop case is a fascinating example of how Club rules can fall behind Milton Friedman's basic rules of society.

The Steam Loop

The Steam Loop, in the words of its promoters, was a process 'designed to secure to steam users economy of fuel, water and power', and in 1890 a company was formed to exploit it. Slaughter and May were solicitors both to the company and to one of the promoters. To ensure a successful launch, the promoters rigged the market by creating an artificial premium on the opening transactions in Steam Loop shares. A dispute over the transfer of shares led to a lawsuit and brought the rigging of the market to the attention of a judge. Such activities were apparently accepted practice in the City at the time, as one of the defendants declared: 'You have only to ask anyone about new companies if it [that is, creating a false premium] is not a necessity'.

The judge, however, took a very different view in his commentary:

> *'...I do say that if persons, for their own purposes of speculation, create an artificial price in the market by transactions which are not real, but are made at a nominal premium merely for the purpose of inducing the public to take shares, they are guilty of as gross a fraud as has ever been committed...'*

Slaughter and May appealed, reckoning that the judge was simply out of touch with the ways of the City. But his judgement was upheld by their Lordships. William May touchingly referred to the case to the end of his life as 'a magnificent miscarriage of justice'.

The case is interesting in many ways. The argument that 'everybody does it' is as readily used to excuse today's scandals as it was in the nineteenth century. The City Club reasoning was that the advantages of an efficient capital market outweighed the disadvantage that some public subscribers for shares were fleeced. The interests of Club members took precedence over those of outsiders to, what turned out to be, an unacceptable extent. The balance between the two sets of interests was wrongly struck. The fundamental problem, at that stage, was that the Club had lost touch with the world outside. In the clash between internal and external rules, the law ruled that fraud was fraud, however much it might be thought to assist the working of the market for new issues. Club members, like William May, had insulated themselves from outside opinion and were no doubt genuinely unaware that the standards expected of business behaviour had changed. Market rigging might have continued but for this chance lawsuit. However, once the fraud involved in company flotations came to light, the practice was clearly illegal and without the rules. It was disclosure which led to the reform of the capital market and to Club rules giving way to the rule of law. This underlines the importance of a governance framework which includes an appropriate mix of external and internal rules.

Nevertheless, the City rules were on the whole effective in maintaining the position of London as a financial centre, although the rules on activities like insider trading were designed not to stop the practice but to keep it under control. The authorities no doubt took as their text, 'Thou shalt not muzzle the ox when he treadeth out the corn'. (Deuteronomy 25.4). Those working in City firms were likely at times to be privy to

market sensitive information and it was accepted that they would use it for their own gain. The rules were aimed at not allowing such self-serving to get out of hand. The rules of the insider trading game were house rules within the overall City rules. Most City houses in the past were partnerships and the house rules and tone of the firm were set by the partners. They gave the lead and ensured that those entering their firms knew what conduct was acceptable and what was not. The reputation of their firms were valuable assets and a close eye was kept on the conduct of those in their employ.

The Breakdown of the City Rules

The Club approach to governance in the City gave way when the cohesion of its members was broken. The efficacy of the Club rules was rooted in the self-interest of the membership in maintaining the reputation of the City and of their own firms within it. It was based on a community of interest and on the personal links between those involved. Those links were broken by a series of momentous changes. One was the sudden expansion of London's financial services sector in the 1980s. Individual firms grew rapidly in size and the rules could no longer be based on personal contact with those at their head. At the same time, the old boundaries between different types of financial activity with their differing rules were swept away. Many of the new entrants to the City did not share the values of what they saw as the past and did not see their futures as lying with a single firm; thus the significance of reputation carried less weight with them. A further change was the influx of foreign firms, as the City became a truly international financial centre. These firms brought their own methods of working with them and were more used to the rules of the game being set statutorily, rather than by conventions of conduct.

The gap in the framework of rules which arose in the much enlarged City was that nothing was put in place of the personal links with the heads of firms. There was no consistent means of passing on business values to newcomers and ensuring that they were adhered to. The rules based on personal example of the earlier City needed to be replaced by more formal rules of conduct. These could no longer be within a framework of City rules, since those had gone. It was up to individual City firms to establish their own codes of conduct. Before, however, discussing such company codes, it is worth pointing out in the context of the internationalisation of the City that the concept of voluntary regulation is a very British one. It is neither well understood nor well accepted elsewhere in Europe.

The Advertising Standards Authority does not have its equivalent on the Continent, nor does the Takeover Panel. The latter is a particularly significant self-regulating body. It rules in a field where the pluses of a non-statutory authority, such as speed of decision, a swift response to new issues as they arise and avoidance of the costs of the legal system, are particularly valuable. Statutory regulation, however, inevitably drives out self-regulation - a kind of inverse Gresham's Law! The Takeover Panel will no longer be able to rule as it does, if the EU legislates on takeovers and mergers. Its authority depends on the acceptance by city practitioners of its rulings. The ability to appeal to a court over a Panel ruling would destroy that authority.

Independence

There is, however, an important governance principle exemplified by the Takeover Panel and which applies to the disciplinary bodies set up by the professions.

in drafting codes of involving those to whom they are to apply. If they are to be expected to abide by codes, they need to have played a part in framing them.

Quite apart from the scepticism with which a code handed down from the board on high, without consultation, will understandably be received, boards are not usually well placed to know how things are done within the enterprises which they direct. I believe that, to be effective, company codes should build on existing standards and embody the best of the existing values of the organisation concerned. They should not be taken off the shelf, so to speak, but should reflect matters that are relevant and important to everyone within a particular company. If they are drawn up in good faith, and provided, crucially, they are backed by example from the top, they have two important attributes.

First, they act as a practical guide to individual employees faced with uncertainty about the courses of action which they should take. Second, they give those whose decisions are questioned, or who question the decisions of others - normally their superiors - a firm basis on which to stand their ground. I, therefore, have no doubt as to the value of company codes in clarifying the rules of the game at company level and in encouraging high standards of conduct.

A company code, however, which is cynically introduced as a façade is likely to have the effect of debasing standards, because it will be seen to reflect the motives of those who drew it up. The same result is likely if there is uncertainty about whether a code truly means what it says. That situation is well illustrated in a price-fixing case brought against General Electric in the US in the 1950s. An account of the case includes the following passage:

> *Some of those who signed 20.5 (the company rule against price-fixing) did not believe it was to be taken seriously. They assumed that 20.5 was mere window dressing, that it was on the books solely to provide legal protection for the company and for the higher-ups; that meeting illegally with competitors was recognised and accepted as standard practice within the company; and that often when a ranking executive ordered a subordinate executive to comply with 20.5, he was actually ordering him to violate it.*

It all, apparently, turned on whether the order was given with a wink or not. The outcome of this confusion over whether the code meant what it said, or the precise opposite, landed some of the 'higher-ups' in gaol. Clearly those who drew up the GE code did not involve those to whom it applied and they seem to have been unaware of the existing standards and practices within their company.

Code Interpretation

Misunderstandings over the meaning of codes raises the issue of the words used in their preparation. An important use of codes is to provide guidance to individuals with uncertainty over the right course of conduct. When attempting to give such guidance in my former company, I had in mind managers out on their own in countries like Nigeria and Indonesia. To have a code of conduct which says magisterially, 'Thou shalt neither offer nor accept bribes', is not particularly helpful to managers on the spot. It begs the question of definition - what is a bribe - and takes no account of local custom. I, therefore, set down two practical rules of thumb which seemed to make sense to those who had met this kind of situation. They were to test whether a

payment made, or gift received, was acceptable from the company's point of view.

For payments, the rule was that they had to be on the face of the invoice; that is to say, they had to go through the books of account. Some bizarre payments came to notice as a result, in developed as well as not so developed countries. However, they met the rule; they were accounted for and audited and, as far as I know, backhand payments in cash or kind were avoided. Accounting for payments may not be sufficient as an ethical test, but payments which are outside the company's system and control will almost certainly be corrupt and corrupting.

On gifts the rule was, 'Would you be happy for your acceptance of a gift to be written up in the company newspaper?' A gift becomes a bribe when it puts the recipient under an obligation to the giver, which could override their duty to the company. There is no set tariff which can measure this degree of obligation and thus determine, by reading off a scale, when the acceptable limit has been passed. However, those who receive gifts and their colleagues can recognise those limits unerringly. If the knowledge that you have accepted something as a gift would be an embarrassment, that limit has been reached. We are back to disclosure. The logic behind both these rules of conduct is that openness and ethics go together and that actions are unethical if they will not stand scrutiny.

The Character of the Company

As chairman of Cadbury Schweppes, I drafted a brief statement of what I felt the company stood for, entitled 'The Character of the Company'. This was circulated around the company, at home and abroad, and formed the basis of discussions with groups of employees when I visited company sites around the world. As a result of those discussions, the final wording reflected the views of as wide a sample as possible of the workforce worldwide. In this way a sense of ownership of the statement was gained throughout the enterprise and it dealt with matters which were relevant to those who read it. In addition, the discussions gave me the opportunity to answer questions about the way in which I thought we in the company should handle difficult issues. The aim was to achieve as wide a degree of agreement as possible on how best to resolve the kind of problems which confront those in business in balancing their duties to people, to the community and to their company. It also meant that individuals faced with decisions, but with no-one on hand to consult, would have a lead as to the course they might take, whether or not in the event they chose to take it.

When I first suggested attempting to set down what the company stood for and then getting agreement to it, some board members were sceptical of its usefulness and said it would simply end up in a filing cabinet. In the event, the degree to which the statement was valued and called on seemed to be a function of distance from the perceived centre of authority. It was the smaller business units and those furthest from the head office in the UK which particularly felt that it filled a need, and it was those lowest down in the hierarchy who turned to it most often.

Although 'The Character of the Company' was not a code as such, it was a statement of values. Values are important both in their own right as aspects of the ethical custom to which Milton Friedman referred and because they are the glue which holds an organisation together in an increasingly fragmented world. Drafting a code is a difficult task, even though there are guides to doing so provided by bodies like the Institute of

Business Ethics. The point to keep in mind is that what may seem platitudinous to the drafter can prove invaluable to those down the line who look to the code for a lead in times of uncertainty.

I believe, therefore, that a governance framework of external rules, embodied in the law, regulations and national codes of best practice, supplemented by internal rules, such as those set by company codes, make up the corporate rules of the game. That still leaves one piece missing from the framework, the rules which we set for ourselves as individuals, the rules by which we live. It is the personal standards of those involved in company affairs which ultimately determine how the rules of the game are applied in practice. In a game of football, it is the player who has the ball at his feet who decides the course of the match, not the referee; the players choose whether to keep the ball in play and whether to abide by the rules or to set them aside.

Personal Responsibility

The same is true of corporate governance. The prime responsibility for business standards lies with boards of directors; however, shareholders, professional advisers to companies, those who comment on business affairs and the wider public, all have a part to play in defining the boundaries of acceptable conduct, in determining the rules of the game. To take a specific example, a Board of Trade enquiry found that Robert Maxwell, 'could not be relied upon to exercise proper stewardship of a publicly quoted company'. The enquiry could not have established his breaches of the rules of the game more plainly. Yet after those findings were published, there were still directors prepared to join his boards, there were shareholders ready to invest in his enterprises and banks eager to lend him money. They could have played to the rules of the game, but they brushed them aside in the hope of gain. Only Maxwell's employees had little opportunity to blow the whistle at his contempt for the rules, since there was no internal code of conduct to which they could appeal.

The Guinness affair provides another instance of a similar kind. There the DTI inspectors said that three findings stood out:

> *Firstly, the cynical disregard of laws and regulations; secondly, the cavalier misuse of company monies; thirdly a contempt for truth and common honesty; all these in a part of the City which was thought respectable.*

The rules of the game can be set externally and internally, but the degree to which they are honoured and are therefore effective is the responsibility of everyone involved in the game, in whatever capacity. Rules of the game have to be established in the corporate world and they need reviewing and updating from time to time in response to the changing scene. They can guide and inspire, but the spirit to which they are played is collectively our responsibility. The bedrock of good governance remains Milton Friedman's ethical custom. We should not lay a greater burden on the law and regulation than they can carry.

The risk in relying too much on statutory rules in corporate affairs is that business and personal morality could come to be seen as distinct and separate. If standards of business conduct are thought of as being primarily set by the law, then compliance with the law could become all that was required, even though keeping on the right side of the law would normally count as a minimum requirement, setting the floor to acceptable conduct. If business standards are to rise, in response to the expectations

which society has of business, then personal morality has to give the lead to business morality; the two should not be divorced. If the two were to be seen as separate, then an increase in statutory intervention could lower standards of business ethics, as regulatory standards took the place of personal standards.

Do Ethical Standards Matter?

The final issue is how far do the ethical customs which are embodied in the rules of the game really matter in an internationally competitive world? They clearly matter to society. Trust has always played a vital part in business, as the authors of the 'Rules for the Conduct of Life' recognised. Trust is in many ways more important today than it was even in the eighteenth century, given the scale and speed of the transactions now carried out through the ether, across national boundaries and impersonally, rather than face to face. In contrast, distrust is a barrier to the flow of trade and of information. If all business had to be based on contract, the pace of trade would be unimaginably slow. Equally, regulation is costly, to an extent that those who ultimately pay for it are usually unaware.

Ethical standards and abiding by the rules matter to companies. If unethical practices are ignored or condoned in a business, there is no means of knowing where the line between acceptable and unacceptable behaviour is to be drawn. The danger is that this uncertainty will result in a downwards slide in standards, which may become cumulative and end in disaster. A further consideration for companies is their need to attract able recruits. A business whose ethical standards are seen to be uncertain has to be at a disadvantage in recruitment, against companies with higher reputations and against other occupations which may be ranked more highly on the ethical scale. Thus business standards matter to individual companies and to the company sector in aggregate.

To conclude: the rules of the corporate game need to be understood and to be backed by all those who are in a position to influence the way in which companies are run. Those at the head of companies should ensure that everyone in their enterprises knows what is expected of them and that their reward system gives credit to those who play to the rules. The rules, from the law downwards, set the framework within which companies carry on their business. The manner in which the rules are applied is the responsibility of individuals within companies. The standards of a company reflect the standards of those who make it up. In the end business morality is personal morality writ large. As Henry David Thoreau observed: 'It is true enough said that a corporation has no conscience. But a corporation of conscientious men is a corporation with a conscience'.

It is to that end that the rules of the game are framed.

GRESHAM COLLEGE

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An independently funded educational institution, Gresham College exists

- to continue the free public lectures which have been given for 400 years, and to reinterpret the 'new learning' of Sir Thomas Gresham's day in contemporary terms;
- to engage in study, teaching and research, particularly in those disciplines represented by Gresham Professors;
- to foster academic consideration of contemporary problems;
- to challenge those who live or work in the City of London to engage in intellectual debate on those subjects in which the City has a proper concern; and to provide a window on the City for learned societies, both national and international.

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