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Article:

Pletz, S. and Upson, J. (2019) The normative evolution of corporate governance in the UK : an empirical analysis (1995-2014). *Corporate Governance*, 19 (5). pp. 1015-1041. ISSN: 1472-0701

<https://doi.org/10.1108/CG-07-2018-0239>

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The Normative Evolution of Corporate Governance in the UK: An Empirical Analysis (1995-2014)

Journal:	<i>Corporate Governance</i>
Manuscript ID	CG-07-2018-0239.R1
Manuscript Type:	Original Article
Keywords:	Financial Market Growth, Corporate Governance Evolution, Empirical Corporate Governance, Shareholder Primacy, Comparative Law, Law and Financial Development

The Normative Evolution of Corporate Governance in the UK: An Empirical Analysis (1995-2014)

Abstract

The UK is at the leading edge of development in modern regulatory corporate governance as a complement to company law. It is observed that the UK follows a shareholder primacy, or Anglo-American corporate governance model prioritising shareholder interests over other stakeholders. Several qualitative studies asserted the UK's position at the forefront of shareholder primacy corporate governance, however, this is the first article which specifically examines the key twenty year period from 1995 -2014 to track changes in UK corporate governance norms against the OECD recommended principles of corporate governance in the context of financial market growth. Specifically, we present a qualitative analysis of the major normative change points in UK corporate governance before assessing the impact of these structural changes in UK corporate governance on financial market growth. This will be achieved by quasi-empirical analysis comparing normative change points empirically, followed by a more traditional structural model. We find that compared to the OECD model of corporate governance, UK corporate governance is less rigid and follows a more self-regulatory approach, based upon a 'comply or explain' model and as such, scoring below countries following compulsory implementation models. Uniquely however, even with such 'low' tilt towards *formal* shareholder primacy norms - the UK has the best performing financial market. As a quasi-empirical study we posit that several historical and economic reasons with a robust rule of law in the UK - contribute to such a performance – and the law especially the type or tilt is less relevant.

Keywords: *Empirical corporate governance, shareholder primacy, comparative law, law and financial development, corporate governance evolution, financial market growth*

Introduction

Simplistically, corporate governance concerns the separation of functions between a company's board of directors and the annual general meeting (AGM) of shareholders or stakeholders. It concerns itself with the balance of power as between the directors at a managerial level, and the shareholders or stakeholders, whose involvement in the company may represent direct or indirect investment through electoral functions. At the most basic level, any division between ownership/investment, and control prompts the risk observed by Smith (1838)¹: 'the directors of such companies [joint stock companies] however being the managers rather of people's money rather than of their own, it cannot be expected that they should watch over it with the same anxious vigilance [as if it were their own]'. The focus of this discussion is to consider how corporate governance has evolved normatively in the UK, benchmarked against the OECD Principles of Corporate Governance 2004, and to provide a quasi-experimental analysis to discuss its impact upon financial market growth.

It is perhaps surprising, in hindsight, that the interest in corporate governance largely represents a *reactive* response, prompted by the catalogue of high impact corporate events from the mid 1990's onwards - highlighted in the UK by the 1995 collapse of Barings Bank, but followed globally by Enron, Royal Ahold, Parmalat, HIH, China Aviation Oil, etc. This is not to suggest that the UK had no means of assuring confidence in the shareholder's position before this time, but rather that the previously relied upon assumptions of the 'traditional corporate governance model' proved to be dramatically inadequate and gave rise to significant questions. In other words, the basic convictions that UK corporate governance had rested upon for so long, that annual reports and audited accounts would provide sufficient confidence and protection for shareholders/stakeholders proved to be too simplistic and perhaps naïve in some instances.

UK corporate governance evolution and development is characterised by the dominant conception of 'shareholder value' widely prevalent in Anglo-American corporate governance, and thereby largely reflective of an agency theory perspective. Simplistically, as reflected by the pioneering research conducted by *Berle and Means* (1932)², pertaining to the separation of ownership and control, the corporate managers are placed in the role of an agent, with the shareholder as principal. The primary managerial focus of directors is rooted in 'fiduciary duty', serving the interests of the company by reflecting the interests of current and future shareholders. Corporate governance in the UK has, therefore, traditionally concerned itself with a rather narrow perspective focusing on the relationship between board members, management, and shareholders, in contrast with some jurisdictions, particularly Germany and Japan, where the function of corporate governance has traditionally addressed the interests of a wider range of stakeholders.

¹ Adam Smith, *The Wealth of Nations* (first published 1776, W. Strathan and T. Cadell 1838) 574

² A Berle and G Means, *The modern Corporation and Private Property* (The Macmillan Company, 1932)

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3 Whilst the foundations of UK corporate governance in the 21st century can be viewed
4 as emerging from the acceptance of the corporate model as a vehicle for wider
5 commercial growth in the 19th century, the focus and scrutiny of the last 25 years
6 activated a structural and normative evolution in governance which continues to rely
7 largely on a regime of self-regulation balanced with statutory guidance. The impetus
8 for such scrutiny emanated from general global commercial growth (typified in the UK
9 by non-familial shareholder investment), the influence of EU harmonisation, OECD
10 recommendations, and perhaps (more significantly) the series of domestic and global
11 economic corporate shocks beginning with Barings and Enron. This article explores the
12 normative evolution of UK corporate governance, considering its impact on the basic
13 assumptions of the UK's 'shareholder value' stance within the Anglo-American
14 position in order to assess its *role* in the context of a company's performance on the
15 UK financial market and financial market development and growth more generally.
16 Firstly we quantify the 2004 OECD Principles into fifty-two individual variables.
17 Secondly we analyse how these factors have evolved in the UK between 1995 and
18 2014. Thirdly, we create an index to chart the development of UK corporate
19 governance in relation to the OECD principles. Fourthly we complement our empirical
20 study by referencing: the position which preceded the period of corporate shock; an
21 overview of the initial Combined Code (1998) growing from the Cadbury, Greenbury
22 and Hampel reports; The Combined Codes (2003, 2006 and 2008); The impact of the
23 Companies Act 2006; the OECD and EU influence; as well as the 2014-2015 Review of
24 the OECD Principles of Corporate Governance, which resulted in the G20 Principles of
25 Corporate Governance demonstrating a greater possible future attunement towards
26 a more enlightened shareholder value (ESV). Finally we merge and graphically
27 visualize the previously discussed UK normative corporate governance development
28 change points with UK financial market development change points before concluding
29 the article.
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38 **Review of Literature**

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40 Researching *effective* corporate governance mechanisms ³ and associated
41 developments such as attributable performance parameters in global and domestic
42 financial markets is increasingly at the centre of academic discourse. Controversially,
43 much of the early scholarly debates on corporate governance functionality adopted
44 monistic perspectives. That means, despite corporate governance developments
45 paralleling dynamic, highly complex, systemic changes such as the proliferation of
46 financial market integration and the emergence of legal transnationalism, scholars
47 predominantly adopted and presented singular, generalist viewpoints. Hence, as a
48 result of systematic corporate governance analysis being a relatively 'young' academic
49 research discipline, existing work can often be characterised as being *intra-* instead of
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57 ³ Corporate governance mechanisms defined as 'base' structural elements in reference to the four
58 basic categories set out by Jensen (1993) 1. Legal and regulatory mechanisms, 2. Internal control
59 mechanisms, 3. External control mechanisms, 4. Product market competition; in Michael C.
60 Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems'
[2003] *The Journal of Finance* 831

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3 *interdisciplinary*, therefore only offering partial, incomplete and static⁴ insight, which
4 we identify to be a serious contentual deficit in present literature.
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7 Since the early days of corporate governance research the composition of global and
8 domestic financial markets and corresponding regulatory framework configurations
9 have been subject to transformative changes that ultimately seek to balance and
10 reconcile corporate performance with effective regulatory oversight mechanisms. In
11 this context it is noteworthy that incessant changes in the 'nature of firms and
12 markets' as *Denis* (2001)⁵ highlighted are likely to 'challenge the more fundamental
13 bases on which our current ideas about corporate governance are built.'⁶ This
14 underlines the importance of empirical, structured research centred on the trajectory
15 of corporate governance evolution in a UK legal context. Despite these key
16 generational developments being reflected in the quantity and variety of corporate
17 governance research literature, produced over the last two decades, we observe
18 further significant methodological shortcomings. Indicative of this is the widespread
19 use of cross-sectional databases⁷ instead of longitudinal databases and/or a
20 combination thereof when analysing historical and current corporate governance
21 development parameters and contextualising these within financial markets and
22 financial market growth. Therefore we establish that the academic analysis produced
23 thus far, lacks a systematic, coherent, critical in-depth approach, based on longitudinal
24 empirical data that refines the conception of corporate governance evolution in a UK
25 legal context. Consequently, for the past two decades it has generally offered more
26 questions than answers to academics and practitioners alike.
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32 An analysis presenting and addressing some of the most pressing research questions,
33 albeit based on more narrow economic perspectives, has been offered by *Kole* and
34 *Lehn* (1997), highlighting that "little is known about the evolution of governance
35 structures"⁸. The authors identify the lack of systematic analysis, including corporate
36 governance structure stability patterns and their parameters.⁹ Significantly, they pose
37 questions surrounding their potential to adapt¹⁰ to dynamically changing corporate
38 environments including the respective *costs* of these potential changes. While *Kole*
39 and *Lehn* introduce the concept of corporate governance evolution and present an
40 interesting line of argumentation, stating that 'firms that fail to adapt their
41 governance structure to changes [...] face extinction, leading to a natural selection of
42 efficient organizational forms'¹¹, which has also been referred to as the 'Darwinian
43 view' on corporate governance organisation, significantly they also acknowledge the
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51 ⁴ Stacey Kole, Kenneth Lehn, 'Deregulation, the Evolution of Corporate Governance Structure, and
52 Survival' [1997] *The American Economic Review* 421

53 ⁵ Diane K. Denis, 'Twenty-five years of corporate governance research ... and counting' [2001]
54 *Review of Financial Economics* 191

55 ⁶ *Ibid*

56 ⁷ *Ibid*

57 ⁸ Stacey Kole, Kenneth Lehn, 'Deregulation, the Evolution of Corporate Governance Structure, and
58 Survival' [1997] *The American Economic Review* 421

59 ⁹ *Ibid*

60 ¹⁰ *Ibid*

¹¹ *Ibid*

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‘absence of evidence’.¹² Similarly and more importantly they also note an absence of a ‘general deeper understanding’ pertaining to the adaptation of the Darwinian view, thereby illustrating its very limitations. While it can be recognised that corporations are increasingly entering an international competition¹³ and as such, are competitors for the best organisational structure, the ‘Darwinian view’ of corporate governance evolution appears too simplistic, excluding various additional factors that contribute to corporate governance evolution, such as geopolitical and/or socio-political¹⁴, technological and other external circumstances. Most significantly however, *Kole* and *Lehn* offer only a monistic economic perspective concentrating on a single industry: the airline industry, which undoubtedly is potent in character but certainly not representative of an entire economy. This produces a somewhat in-depth - yet compartmental and thus incomplete perspective. Therefore our empirical evidence based on longitudinal analysis intends to fill this gap by offering a multidimensional approach to UK corporate governance evolution in the context of the OECD regulatory principles.

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A more analytical robust and historically detailed analysis is offered by *Coffee* (1999)¹⁵ and later by *Cheffins* (2001)¹⁶. Despite *Coffee’s* research being largely US centred, he frequently references and historically contextualises developments in UK corporate governance, which produces insightful comparative perspectives. Significantly, in consideration of the scope and extent of this research paper, *Coffee* addresses highly relevant normative questions pertaining to corporate governance evolution in his work, such as divergence and convergence trends. These trends must be considered as important present and future characteristics of UK corporate governance evolution. Interestingly *Coffee* concludes that the law only plays a minor¹⁷ role: ‘investors depend on relationships, not law’¹⁸ which notably our research supports with empirical evidence. Moreover both, *Coffee* (1999) and *Cheffins* (2001), highlight the UK’s unique¹⁹ corporate governance position in western financial markets by reference to the design and evolution of its regulatory framework. Pioneering efforts by both authors, offer a more substantial comparative finance-historical context to corporate governance evolution and fill some important gaps in the literature by setting their research findings into a useful, larger multidisciplinary framework. However both authors contribute largely *descriptive* pieces of work that not only lack empirical evidence but more significantly fail to thematise and subsequently scrutinise

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¹² Stacey Kole, Kenneth Lehn, ‘Deregulation, the Evolution of Corporate Governance Structure, and Survival’ [1997] *The American Economic Review* 421

¹³ J Gordon and M Roe, *Convergence and Persistence in Corporate Governance* (Jeffrey N. Gordon and Mark J. Roe eds, CUP 2010)

¹⁴ Marianna Belloc and Ugo Pagano, ‘Co-evolution of politics and corporate governance’ [2008] *International Review of Law and Economics* 106

¹⁵ John C. Jr. Coffee, ‘The future as history: the Prospects for Global Convergence in Corporate Governance and its Implications’ [1999] *Northwestern University Law Review* 641

¹⁶ Brian R. Cheffins, ‘History and the Global Corporate Governance Revolution: The UK Perspective’ [2001] *Business History* 87

¹⁷ John C. Jr. Coffee, ‘The future as history: the Prospects for Global Convergence in Corporate Governance and its Implications’ [1999] *Northwestern University Law Review* 641

¹⁸ *Ibid*

¹⁹ Brian R. Cheffins, ‘History and the Global Corporate Governance Revolution: The UK Perspective’ [2001] *Business History* 87

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3 the most important period of UK corporate governance evolution: the last two
4 decades, which define significant corporate governance reforms. Given the
5 exponential rise in corporate governance regulatory frameworks during these two
6 decades both research approaches are insightful but remain incomplete and therefore
7 unsatisfactory.
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10 *Keasey, Thompson and Wright* (2005) delivered one of the first comprehensive,
11 descriptive monologues on the development of UK corporate governance. In that
12 sense this paper presents a methodological as well as an interpretative advancement
13 of their theories in aspects. Amongst other things the authors introduce and discuss
14 relevant significant corporate governance parameters, such as the role of financial
15 market structures, the role of the *normative* 'nature of the corporate form'²⁰ and the
16 influence of regulatory institutional frameworks. In this respect the work by *Keasey,*
17 *Thompson and Wright* has laid the groundwork for corporate governance
18 development analysis. Certainly its greatest strength is illustrated in their continuous,
19 critical approach, which pertains to elaborate on challenges, and particular
20 problematic issues surrounding this research area. This means that the authors
21 address, critically contextualise, and juxtapose several aspects of proponent and
22 opponent viewpoints relating to corporate governance systems and structures.
23 However the work of *Keasey, Thompson and Wright* does appear incomplete. It falls
24 short in presenting at least one detailed, longitudinal empirical analysis of the relevant
25 corporate governance parameters mentioned above. Our research paper intends to
26 fill this gap by providing the first longitudinal, empirical analysis that covers the most
27 significant, recent corporate governance development period from 1995-2014,
28 critically analysing *and* contrasting individual UK norms against the respective
29 regulatory OECD principles to provide empirical evidence relating to the role,
30 evolution and configuration of 'law' in the context of UK corporate governance
31 performance.
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43 *De Nicolo, Laeven and Ueda* (2007) published an interesting empirical, longitudinal
44 (1994-2003) study that analyses cross-country *quality* of corporate governance,
45 specifically examining 'reforms, new laws and regulations' in the context of a
46 corporation's financial performance. Their study heavily scrutinises and contextualises
47 empirical data constructing a *corporate governance quality* (CGQ) index. The evolution
48 of this quality index is observed between the years 1995-2014 and the 'impact of
49 measured improvements on output growth, productivity growth' and investment on
50 country level and on industry growth is assessed. Controversially their analysis on
51 corporate governance quality evolution suffers from three substantial deficits, which
52 our research attempts to rectify. Firstly their set parameters on defining 'corporate
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59 ²⁰ Kevin Keasey, Steve Thompson and Mark Wright (eds), *Corporate Governance – Accountability,*
60 *Enterprise and International Comparisons* (John Wiley & Sons 2005)

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3 governance quality – in trends and real effects’ are highly subjective. The authors did
4 not define nor explain their definition and/or categorisation parameters in the context
5 of ‘quality’. Given that the term quality can itself be viewed as highly subjective, the
6 author’s research outcome logically implies a great(er) subjectivity and can therefore
7 not be viewed as suitable for drawing more generalised conclusions. This undermines
8 the paper’s significance and consequently lessens its analytical effectiveness.
9 Secondly *De Nicolo, Laeven and Ueda* explain that they are using ‘outcome based
10 measures’ of corporate governance, as opposed to ‘*de jure*’ measures’.²¹ Despite the
11 authors illustrating several advantageous aspects of the ‘outcome based measures’
12 approach, it nonetheless appears to be deficient. That means the authors argue that
13 analysing ‘*de jure*’ measures of corporate governance is ‘difficult’. While this in
14 principle is true, establishing ‘*de jure*’ subcategories that incorporate and structure
15 the variety of legal corporate governance regimes would complement the ‘outcome
16 based analysis’, without sacrificing important legal analytical elements. In other
17 words, their contribution would have been enhanced by a combination of the two.
18 Additionally *De Nicolo, Laeven and Ueda* offered a relatively short time frame analysis
19 of only nine years, more significantly excluding the years centring on the financial
20 crisis. It is this particular gap that our research fills, by offering a crucially longer
21 empirical analysis including not only the important 2007-2009 time period but also
22 offering a *combined* analysis of economic and legal factors pertaining to UK corporate
23 governance evolution.
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34 In 2009 *Arcot, Bruno and Faure-Grimaud* presented an empirical micro-regulatory
35 analysis²² that focuses on the role of the law pertaining to the functionality of the
36 ‘comply or explain’ approach, enshrined in the ‘UK Corporate Governance Code’. Their
37 contribution firstly dissects the characteristics of ‘the Code’ by contrasting its
38 regulatory flexibility with more mandatory, statutory corporate governance regimes
39 and secondly contextualises and discusses these finding in terms of whether this
40 voluntary compliance ‘comply or explain’ is working, i.e. analysing their *effectiveness*
41 in terms of monitoring and enforcement. While the authors discuss fundamental
42 aspects of UK corporate governance in relation to soft law versus hard law
43 approaches, their work appears somewhat simplistic and overly generalising.
44 Consequently their line of argumentation suffers from a mono-perspectival analysis.
45 Given that corporate governance analysis in any context is a highly complex process,
46 the author’s approach remains unpersuasive. Symptomatically, the authors assert
47 that ‘a more statutory regime [to corporate governance] would lead to a “box-ticking”
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57 ²¹ Gianni De Nicolo, Luc Laeven, Kenichi Ueda, ‘Corporate governance quality: Trends and real
58 effects’ [2008] *Journal of Financial Intermediation* 198

59 ²² Sridhar Arcot, Valentina Bruno, Antoine Faure-Grimaud, ‘Corporate Governance in the UK: Is
60 the comply or explain approach working?’ [2009] *International Review of Law and Economics*
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3 approach'.²³ This statement fails to recognise the objective, almost technical precision
4 of more statutory legal regimes, which by no means must result in a mere box-ticking
5 approach. Therefore the authors clearly refer to characteristics of the *implementation*
6 of this approach and not to its inherent, underlying (useful) structural elements. That
7 means not only do the authors fail to present quantifiable data and/or hermeneutical
8 evidence to support their assertion, conversely they also generalise specific
9 characteristics of 'more statutory regimes', which in actual fact represent the majority
10 of global legal systems, in order to support their theory. Thus their analysis, despite
11 offering some useful insight remains undifferentiated, limited to largely broad-brush
12 comparisons.
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18 Several years later *Matos and Faustino (2012)*²⁴ introduced an insightful
19 complementary piece of empirical research that applies econometric estimation
20 techniques to the analysis of European corporate governance evolution, specifically in
21 the context of convergence.²⁵ Although the analysis is very short it poses a number of
22 interesting and important questions, such as does the level of corporate governance
23 convergence across European countries correlate to a specific legal/institutional
24 framework? Thereby the authors significantly link and explore empirical corporate
25 governance analysis to particular "cultural and political facets relevant to the
26 convergence process". It is this conceptual interdisciplinarity that furthers the
27 academic discussion in this field substantially, as the authors demonstrate that the
28 convergence process differs between the Anglo-American and Continental models of
29 corporate governance. Significantly this means that authors produce evidence that
30 the regulatory framework, and more specifically the law, matter. Our paper goes
31 further by exploring exactly *how* we think it matters. However the authors themselves
32 identify a number of shortcomings in their work, namely the lack of additional control
33 variables allowing for a more dynamic analysis. This gap is filled by our empirical
34 analysis.
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44 Finally *Zalewska (2014)*²⁶ presents a qualitative post Cadbury and Sarbanes-Oxley
45 corporate governance analysis²⁷ pertaining to specific challenges in the context of
46 regulatory advancements, significantly claiming that 'governments, regulators and
47 shareholders have, since the 1990s, transformed the natural *evolution* of corporate
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52 ²³ Sridhar Arcot, Valentina Bruno, Antoine Faure-Grimaud, 'Corporate Governance in the UK: Is
53 the comply or explain approach working?' [2009] *International Review of Law and Economics*
54 193

55 ²⁴ Pedro Verga Matos, Faustino C Horacio, 'Beta-convergence and sigma convergence in
56 Corporate Governance in Europe' [2012] *Economic Modelling* 2198

57 ²⁵ Anna Zalewska, 'Challenges of corporate governance: Twenty years after Cadbury, ten years
58 after Sarbanes-Oxley' [2014] *Journal of Empirical Finance* 1

59 ²⁶ *Ibid*

60 ²⁷ *Ibid*

governance into a *revolution*'.²⁸ The author discusses the question as to what caused the dramatic regulatory changes in that period highlighting the individual regulatory steps taken by the different legislators (UK and US). Despite offering an interesting comparative legal analysis between UK and US corporate governance regulatory reforms, the contribution lacks greater in-depth critical analysis that explores the correlation between financial markets and the law; it also fails to empirically link and contextualise these findings. Therefore *Zalewska's* work appears incomplete and remains somewhat superficial in its research approach.

To conclude, previously produced literature and research findings on empirical UK corporate governance evolution, considering longitudinal data sets that cover a sufficiently long and crucial time period (e.g. the financial crisis) appear insufficient and significantly under researched. As demonstrated above current literature lacks in-depth critical analysis that contextualises the role of the law *in conjunction* to a company's performance on the UK financial market. It has been asserted that the "law clearly matters"²⁹ but at the same "just how is less than clear".³⁰ We present evidence to demonstrate that law does in fact play a role, but that role is a different, more differentiated one.

Methodology

The 2004 OECD Principles of Corporate Governance constituted the major piece of international regulation, which gained widespread attention in the early part of this century. Most developing countries fashioned their corporate governance regulations based on these principles. Thus from a comparative law perspective the OECD principles provide a touchstone to measure to what extent a country has adopted the generally recognised uniform corporate governance principles. Another dimension worthy of exploration is the tilt towards shareholder primacy corporate governance, although a lip service is paid to stakeholderism as OECD principles mostly tend to lean towards shareholder primacy corporate governance. Thus an empirical analysis which studies the evolution of UK corporate governance pegged to the 2004 OECD standard would also reveal the increased or decreased tilt to shareholder primacy corporate governance.

We analyse fifty-two variables each of which is capable of three basic answers: absent, optional or not widely enforced, and compulsory or widely enforced. Thus the study tries to bridge the gap between law in books and law in action. We also move beyond

²⁸ Anna Zalewska, 'Challenges of corporate governance: Twenty years after Cadbury, ten years after Sarbanes-Oxley' [2014] *Journal of Empirical Finance* 1

²⁹ R Morck and L Steier, *The global history of Corporate Governance: an Introduction* (Randall K. Morck ed, University of Chicago Press 2005)

³⁰ *Ibid*

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3 the binomial paradigm of presence or absence of law in books, which still finds favour
4 in much empirical work. A brief variable description is given in Appendix A, it is
5 thematically divided into four subcategories Anti-Stakeholder rights index, Minority
6 shareholders rights index, Anti-Managerial rights index and Shareholder rights index.
7 The completed questionnaire for the UK for 1995-2014 is available in Appendix B. The
8 coded table is available in Appendix C.
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13 An item response model with Kalman filter is used to compress the data into an index.
14 Computer codes for the same are available in Appendix D. For a quasi-experimental
15 analysis of the impact we also look at five financial market variables namely - S&P
16 global equity index, traded volume of stocks traded, Number of listed domestic
17 companies, Market capitalisation of listed companies, and Foreign Direct Investment
18 (FDI). An explanation of the variables is available in Appendix E. These five variables
19 are melded into a financial market development index by executing a Bayesian factor
20 analysis. The computer code is available in Appendix D.
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26 In undertaking the quasi-experimental analysis exploratory techniques like change
27 point analysis are first used. This will show the time period when change(s) has/have
28 occurred in the overall normative corporate governance evolution in addition to
29 financial development. This will help to pinpoint whether corporate governance
30 'improvements' follow financial boom or if it is the other way round. We use the R
31 package bcp to implement the change point solutions.³¹
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36 **Historical Context**

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38 It is notable that the UK is predominantly a Common Law jurisdiction (although it
39 should be recognised that Scottish Law is a hybrid Civil/Common Law system rooted
40 in Roman law). Principally the impact of the common law is felt in two effects, firstly,
41 legislation may anticipate, and give authority to further detail, provided as secondary
42 legislation, or regulation, and that the courts have an interpretative role where
43 legislation is brought before them; and secondly, that law – the Common Law - is
44 developed through the courts quite separately to the provisions of Parliament.
45 Legislation is by its nature less detailed and all encompassing than might be the case
46 in Civil law jurisdictions, allowing Parliament to revisit as necessary, without disruption
47 of any wider design. The English courts interpret and apply legislation, but also
48 adjudicate on issues outside of statute in common law developing law through binding
49 precedent or *Stare Decisis*. This background is useful in providing the context of the
50 development of corporate governance in the UK.
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59 ³¹ bcp: Bayesian Analysis of Change Point Problems <[https://cran.r-](https://cran.r-project.org/web/packages/bcp/index.html)
60 [project.org/web/packages/bcp/index.html](https://cran.r-project.org/web/packages/bcp/index.html)>

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3 The core of the 20th century approach to the establishment and governance of
4 companies is founded in the legislative provision of the first half of the 19th century.
5 The legislation from 1844 onwards established the pattern for the incorporation of
6 companies in the UK, and thereby the theoretical presumptions, which have formed
7 the basis of the UK approach to corporate governance throughout the major part of
8 the 20th century. Until the period of legislation beginning with the Joint Stock
9 Companies Act 1844 the exception to the 'unincorporated joint stock company' were
10 those relatively limited examples of companies created by Royal Charter or Private Act
11 of Parliament. The former not insignificant in giving rise to esteemed organisations
12 and pillars of society, and the latter facilitating significant sectoral industrial progress,
13 e.g. through the railways.
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20 Potential for growth in the dominant model of the 'unincorporated joint stock
21 company' however became, limited and failing to meet the appetite for economic
22 growth. Moreover, the demands of industry and commerce were two-fold:
23 incorporation and limited liability. Whilst the former was provided by the Joint Stock
24 Companies Act 1844 (the Gladstone Act) the latter was rather more controversial. The
25 call for limited liability to be enshrined in statute rested upon a number of differing
26 arguments. Principally, it was argued that 'limited liability' was needed to provide
27 security for small investors who would otherwise remain outside of industrial
28 development, and thereby restrict the potential pool of investors essential for
29 continued economic growth. At this time a distinction was also drawn between those
30 investors who had been able, by the terms of their contractual relationship with the
31 subject company, to exclude potential liability, and those who had not been able to
32 secure such an advantageous position. As a contract is an obligation created and
33 policed by the parties themselves, it would be beyond the control of Parliament, and
34 the differential position of those with contractual protection and those without could
35 therefore only be addressed by legislation imposing a broader limitation of liability as
36 represented by the Limited Liability Act 1855; the combined position better facilitating
37 the corporate economy (Hannah, 1983)³². Although the legislative framework has
38 been added to from time to time, the shape of company formation and governance
39 was largely established until the late 20th century with the emergence of the current
40 focus on corporate governance.
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51 The *laissez-faire* principles dominant in the 19th century remained influential in the
52 20th century, not least in relation to the general hands-off, non-interference stance
53 directed towards the growing corporate economy (Hunt, 1936)³³. The immanent
54 principles relating to property rights became extended to corporate property,
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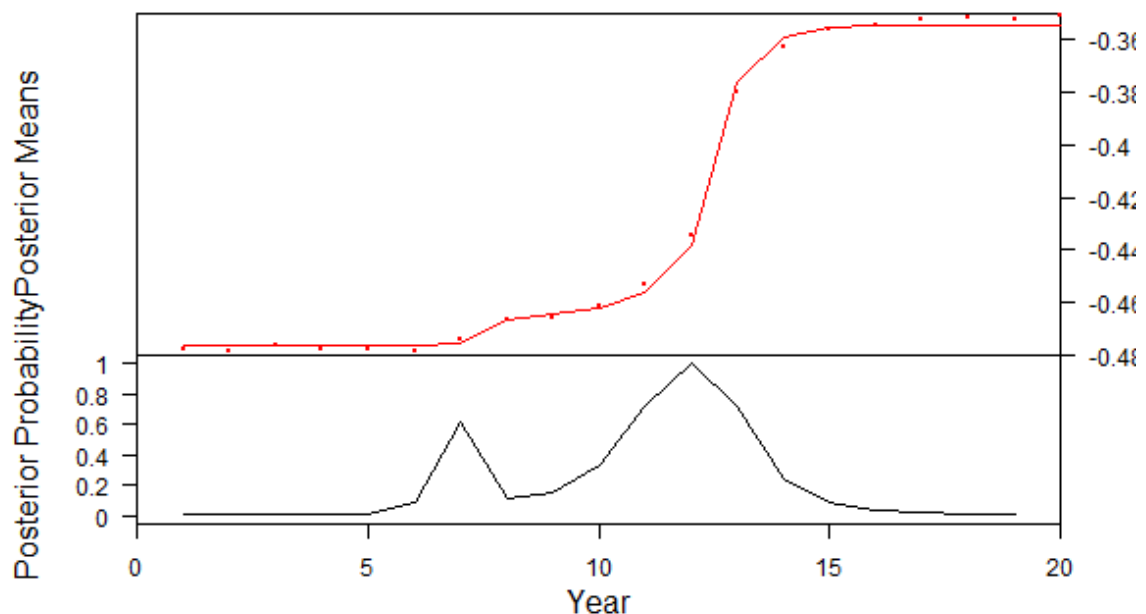
58 ³² Leslie Hannah, *The Rise of the Corporate Economy* (2nd edn, Methuen 1983)

59 ³³ Bishop C. Hunt, *The Development of the Business Corporation in England 1800 – 1867* (Harvard
60 University Press 1936)

notwithstanding their incorporation, influencing the emergence of the doctrine of shareholder value. However, beyond this there is little evidence of further overt development in terms of corporate governance during this period, suggestive not least of a lack of interest on the part of successive governments. The reasons are no doubt complex, but may be summarised on the part of Conservative governments on the basis that the status quo presented no real issues at the time. In contrast, it might seem surprising that the post-war Labour governments were similarly silent, the answer here may simply be that their interests lay elsewhere, principally in relation to the focus on public ownership and the development of the Welfare State. During the period of the Blair/New Labour government starting in 1997, the outlook of the Labour party had changed, and domestic and global corporate events meant that the subject of corporate governance could no longer be ignored. However, that is not to say that the Labour government had shown no interest, as indicated by the report of the Committee of Enquiry into Industrial Democracy (1977), otherwise known as the Bullock Report. The report, which was in response to the European Commission's draft 5th Company Law Directive sought to harmonise worker participation in management proposing a form of worker involvement within company governance. Whilst this might have been viewed as representative of a move towards a broader stakeholder perspective, we should not overlook the fact that the recommendation also presented a potential means of addressing the inherent problems of a period of enduring industrial dispute.

Empirical analysis of corporate governance evolution in UK

Changepoint in corporate governance development in United Kingdom



The change in corporate governance in the UK in the last twenty years is minimal, but the probability of any change point in the last twenty years is highest in year 12 (probability: 1) with minor changes in year 7 (probability: 0.62), year 11 (probability: 0.72) and year 13 (probability: 0.72). The major shift corresponds to the year 2006 with minor shifts in 2001, 2005 and 2007. These shifts can be attributed to the publication of several non-binding codes such as good practice suggestions from the Higgs Report³⁴ and the publication of the Combined Code on Corporate Governance by the Financial Reporting Council (FRC) in 2006; the Myners Report³⁵ and the Code of Good Practice³⁶ by Association of Unit Trusts and Investment Funds in 2001; and on Internal Control: the Revised Guidance for Directors on the Combined Code published by FRC in 2005 etc. The above highpoints will now be discussed in greater qualitative detail.

The Combined Code 1998

The Combined Code 1998, prompted by the collapse of Barings Bank etc, incorporated the key elements of the Cadbury³⁷, Greenbury³⁸, and Hampel³⁹ reports, disseminating what should be 'best practice' in corporate governance (Parkinson and Kelly, 1999)⁴⁰. The compliance strategy adopted relied on voluntary disclosure, through the mechanism of 'comply or explain'. The self-regulatory approach might be viewed quizzically by some, but the requirement to 'explain' supports transparency, and presented something of a challenge to companies with effective self-regulation reducing the need for future statutory control (Gamble and Kelly, 2001)⁴¹.

The Combined Code represents a reactive stance. The influential Cadbury Report itself was a private initiative established by the Financial Reporting Council, the London Stock Exchange and the accountancy professions, in response to a series of high profile corporate events. Indeed, the nature of the initiative allowed the enquiry to broaden its remit in the light of further incidents (particularly BCCI and Maxwell). The broad aim of the Committee was to raise standards of financial reporting and accountability in UK listed companies, although its impact was in fact more widespread, influencing the development of corporate governance codes more widely.

Whilst primarily focused on the need to enhance standards of financial reporting and accountability, the approach taken by Cadbury envisaged that the board would

³⁴ Financial Reporting Council (FRC), 'Good practice suggestions from the Higgs Report' (2006)

³⁵ HM Treasury (2001) *Institutional Investment in the UK: A Review* Paul Myners

³⁶ Association of Unit Trusts and Investment Funds, 'Code of good practice' (2001)
<<http://www.ecgi.org/codes/documents/autif.pdf>>

³⁷ Sir Adrian Cadbury, *Report of the Committee on the Financial Aspect of Corporate Governance* (Gee & Co. Ltd. 1992)

³⁸ Sir Richard Greenbury, *Directors Remuneration* (Gee & Co. Ltd. 1995)

³⁹ Sir Ronnie Hampel, *Committee on Corporate Governance: Final Report* (Gee & Co. Ltd. 1998)

⁴⁰ John Parkinson, Gavin Kelly, 'The Combined Code on Corporate Governance' [1999] *Political Quarterly* 101

⁴¹ Andrew Gamble, Gavin Kelly, (2001) 'Shareholder Value and the Stakeholder Debate in the UK' [2001] *Corporate Governance* 110

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3 nonetheless be enabled to push the company on to take advantage of a competitive
4 environment, albeit with the expectation of accountability, even though of a voluntary
5 nature. It was not intended to lead to corporate sterility, but rather ensure a higher
6 level of Best Practice highlighting transparency within a voluntary regulatory
7 framework, where compliance may not always be demanded, but must always be
8 explained.
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13 Recommendations of the Report on the Financial Aspects of Corporate Governance
14 (Cadbury), focused on the reporting function, and relationship between board, audit,
15 and shareholders. The Code of Best Practice being based upon the key precepts of
16 openness, accountability, and integrity. The comprehensive framework represented
17 in Cadbury sought, inter alia, to define a template for clear and transparent
18 governance, from the need for regular board meetings retaining effective control and
19 oversight of the executive management, to recognition of the value of nonexecutive
20 directors both in bringing an independent perspective in relation to strategy and
21 performance, and providing a measure of independence on questions of
22 remuneration, to attention to the relationship with auditors with reference to both
23 audit and non-audit services etc.
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30 The later Greenbury Committee, an initiative of the CBI, reporting in 1995 in response
31 to public and shareholder concern over director remuneration, followed Cadbury
32 quite swiftly. Whilst the focus of Greenbury was much narrower than Cadbury, they
33 shared a commonality of theme, particularly in relation to accountability,
34 responsibility, transparency and full disclosure, the alignment of director and
35 shareholder interests, and improved company performance, in addition to the
36 headline concern relating to directors' remuneration.
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40 The final limb of the triumvirate leading to the Combined Code is represented by the
41 Hampel Report. The Hampel Report on Corporate Governance (1998) came from an
42 initiative of the Financial Reporting Council. Its remit whilst broader than Cadbury and
43 Greenbury, built upon the earlier reports, generally endorsing the findings of each of
44 them. Hampel, however, does go further than its predecessors in emphasising the
45 significance of the institutional investors themselves, in relation to the governance of
46 the investee companies. The overall theme of transparency communicated by the
47 earlier reports, however, remains evident.
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52 Drawing from the 3 reports the Combined Code 1998 addresses two broad themes:
53 the first relating to the governance of companies, calling on the board to 'maintain a
54 sound system of internal control to safeguard share-holders' investment'; the second
55 focusing on the institutional investor. Relying upon the detailed considerations of
56 Cadbury, Greenbury, and Hampel, the Combined Code represents a timely and
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3 effective response to the emerging millennial corporate landscape. The compliance
4 strategy of 'comply or explain' established the pattern of the UK regulatory approach.
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7 **The Revised Combined Codes**

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10 The basic template for corporate governance in the UK provided by the original
11 Combined Code has been revisited on several occasions (2003, 2005 and 2006). The
12 first in 2003 responding to, and incorporating the key recommendations of both the
13 Higgs, and the Smith reports, with later updating taking place in 2005 and 2006 before
14 the major revision in 2010 (see below).
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18 Higgs⁴², reporting in 2003, was tasked with a review of the effectiveness of the existing
19 provision in relation to non-executive directors, and the audit committee. As had been
20 the case on previous occasions, the review of the provision in UK law was timely in the
21 light of the reverberations of yet another corporate scandal, in this instance Enron.
22 The failings of Enron related not only to their own activities, but extended to their
23 auditors who had failed to press directors hard enough in relation to concealed losses.
24 The comparison with the UK response in the Higgs review, and that of the USA is
25 striking. Whereas the former continued in supporting the existing UK non-
26 prescriptive, 'comply or explain' approach, the latter introduced the Accounting
27 Industry Reform Act 2002 (Sarbanes-Oxley Act), protecting investors from fraudulent
28 accounting by corporations by imposing mandatory requirements on CEO's and CFO's
29 supported by serious criminal sanctions. Higgs did recommend more stringent
30 requirements in relation to both the membership of boards and the appraisalment of
31 independent directors, but nonetheless remains loyal to the non-prescriptive
32 approach. The impact of the Sarbanes-Oxley Act cannot, however, be ignored as the
33 sphere of application is not strictly limited to US companies, but extends to both US
34 and non-US companies, even where the Act may be in direct conflict with the home
35 nation's domestic regime of corporate governance. The effect has been for some
36 companies to choose to become delisted from the NYSE, and for others to be
37 dissuaded from applying.
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48 The Smith Review (2003) also reflected the significance of the company audit
49 committee, and the necessary independence of auditors. In relation to the former,
50 Smith impressing the significance of the role to 'ensure that the interests of the
51 shareholders are properly protected in relation to financial reporting and internal
52 control' (para 1.5), further underpinning the shareholder value approach in UK
53 corporate governance.
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56 **The UK Corporate Governance Code**

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60 ⁴² Derek Higgs, *Review of the Role and Effectiveness of Non-executive Directors* (DTI 2003)

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3 In 2010 the Combined Code was revised, in the light of the Davies and Sharman
4 Reports, and re-designated as the UK Corporate Governance Code (with further
5 updates following in 2012 and 2014). The updated code does not represent any
6 distinct change of direction, but does introduce a new focus on 'diversity disclose' in
7 relation to director mix, and stresses the need to set the right 'tone from the top'.
8 Beyond this development, the significance of the revisions relate largely to the
9 continuing themes of: risk management and internal control; remuneration (stressing
10 the need to link to delivery of long-term benefits to the business); and shareholder
11 engagement.

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15 Whilst the 2010 code, as updated, does not present any radical change of direction,
16 the significance of a regularly updated and informed code is representative of a
17 mature controlled approach to corporate governance, albeit one that remains largely
18 reactive in nature.

21 **The Companies Act 2006**

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24 Since its emergence in the Cadbury Report, corporate governance in the UK has largely
25 relied upon a narrow outlook, focusing on profit maximisation through the
26 prioritisation of the shareholder. We have, however, already noted that this is not the
27 only approach that might be adopted, nonetheless although Hampel (para 1.3)
28 suggests that good governance will ensure that stakeholders with an interest in the
29 company will be taken into account, it is difficult to see this as reliable in such a
30 shareholder centric framework. Broader definitions have been mooted (Sheridan and
31 Kendall, 1992)⁴³, and are more characteristic of some other jurisdictions, and
32 particularly relevant to some other EU jurisdictions, and the process of EU
33 harmonisation. The 1999 Consultation Document (Modern Company Law for a
34 Competitive Economy: The Strategic Framework), reflected upon broader interests
35 which may be served, drawing a distinction between the 'enlightened shareholder
36 value' approach which would suggest that such interests could be benefited within
37 the present framework, and a 'pluralist' approach which would facilitate the wider
38 stakeholder interest, but would demand significant changes to company law with,
39 particular impact on directors.

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45 Much of the development of corporate governance in the UK to this point has rested
46 upon the notion that the governance of the company is presumed to be solely in the
47 interest of the shareholder. We may note the terms of s 309 of Companies Act 1985,
48 which provides that directors should have regard to the 'interests of the company's
49 employees', but it is suggested that this did not make significant inroads on the
50 shareholder/stakeholder debate, not least for the reasons identified below.

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54 The Companies Act 2006 represented a timely and necessary review of the law, taking
55 the opportunity to reflect upon the pre-existing position focusing on the shareholder,
56 but encouraged by the Company Law Review, to adopt a more 'enlightened
57 shareholder' approach. This is particularly reflected in s 172 which establishes a

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60 ⁴³ T Sheridan and N Kendall, *Corporate Governance, An Action Plan for Profitability and Business Success*, (Financial Ties/Pitman Publishing 1992)

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3 broader duty on directors, acting in good faith, to 'promote the success of the
4 company for the benefit of its members as a whole', having regard to a (non-
5 exhaustive list) of considerations including: reference to the long-term consequence
6 of their decisions; the interests of employees; relationships with other stakeholders
7 (suppliers, customers etc.); the wider community and environment; maintaining the
8 reputation and standards of the company; and the obligation to 'act fairly as between
9 members of the company'.
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13 Taken at face value, s 172 would seem to support a change of direction in corporate
14 governance in the UK, broadening corporate responsibility from a narrow shareholder
15 perspective, to a wider community of stakeholders. However, it continues to be the
16 case that shareholders remain the principal focus, with the secondary stakeholder
17 interests only being relevant to the extent that the directors, acting in good faith,
18 consider it necessary/appropriate to have regard to them, when acting 'for the benefit
19 of its members as a whole'. Further, it should be noted, that any opportunity to
20 challenge the exercise of the directors' discretion under s172 is, arguably, limited to
21 the point of sterility. The decision to litigate lies with the directors, meaning that those
22 allegedly acting contrary to the Act may themselves have sufficient weight to block an
23 action, even where a fully independent board considers it necessary to 'promote the
24 success of the company' under s172. Which perhaps questions the extent to which
25 s172 represents any real change in the shareholder value perspective. This is not a
26 new problem, but one, which also restricted the practical significance of s 309 of the
27 1985 Act (Keay, 2007)⁴⁴.
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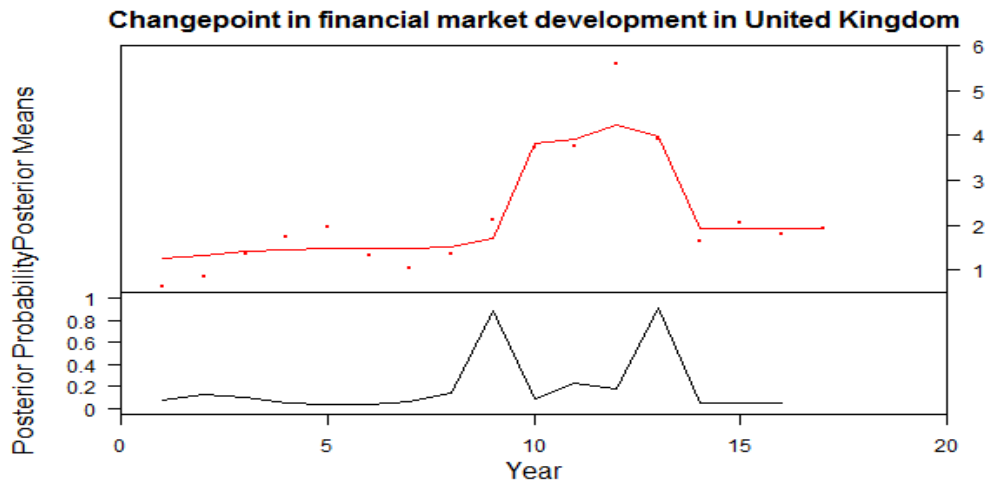
32 **The Stewardship Code 2010**

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35 Emanating from the Financial Reporting Council, the Stewardship Code attends to the
36 position of institutional investors with voting rights, extending expectations in relation
37 to transparency to their voting, and voting policy. The practical effect of the code is to
38 enhance the engagement of institutional investors, which in turn will pay dividends in
39 relation to the corporate governance of the investee company, and encourage
40 openness and transparency in relation to their own compliance in the investor's home
41 company. The approach encourages transparency in relation to the stewardship
42 function, giving a two-way benefit, maintaining continuity with the 'comply or explain'
43 model.
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47 **Development in Financial Market Growth**

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⁴⁴ Andrew Keay, 'Tackling the Issue of Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach' [2007] Sydney Law Review 577



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The probability of change points in UK financial market development is highest for year 9 (probability: 0.88) and year 13 (probability: 0.91), corresponding to the years 2004 and 2008 respectively. There was a sustained upswing in the financial market in the UK from 2003 to 2007, which Ben Bernanke ‘argued that, probably thanks to better theory of monetary policy, the world had entered the era of “great moderation”, in which the volatility of prices and outputs is minimised.’⁴⁵ The FTSE regained the height of the late 1990s dotcom boom.⁴⁶ Mervyn King, the then Governor of the Bank of England termed the years as the ‘nice’ (non-inflationary consistently expansionary) decade,⁴⁷ which Gordon Brown, the then Chancellor of the Exchequer, claimed helped solve the ‘boom and bust’ economics leading to ever greater economic growth.⁴⁸ It is postulated here that deregulation and the ‘benign macro-economic situation encouraged investment in both capital and financial investments. [...] Financial institutions became willing to take on more risky investments because they were more confident that there would not be any major economic downturn.’⁴⁹ This nonetheless led to the Global Financial Crisis of 2008 and

45 Ha-Joon Chang, ‘This is no recovery, this is a bubble – and it will burst’ *The Guardian* (London, 24 February 2014) <<http://www.theguardian.com/commentisfree/2014/feb/24/recovery-bubble-crash-uk-us-investors>>

46 BBC, ‘Investors celebrate stock market boom’ (31 December 2003) <<http://news.bbc.co.uk/1/hi/business/3359241.stm>>

47 Speech given by Mervyn King, Leicester 14 October 2003 as cited in Treasury Committee, House of Commons, *Banking Crisis: Dealing with the Failure of the UK Banks : Report, Together with Formal Minutes* (Seventh report of session 2008-09) 12

48 Deborah Summers, ‘No return to boom and bust: what Brown said when he was chancellor’ (*The Guardian*, 11 September 2008) <<http://www.theguardian.com/politics/2008/sep/11/gordonbrown.economy>> accessed 15 May 2015

49 Tejvan Pettinger, ‘The Great Moderation’ (*Economics Help*, 21 February 2013) <<http://www.economicshelp.org/blog/6901/economics/the-great-moderation/>> accessed 15 May 2015

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3 the London Stock Exchange suffered the worst fall in its history.⁵⁰ As shown in the
4 graph above, the post-2008 the financial market fell back to its pre-2004 level.

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6 Therefore we find little correlation between the changes in corporate governance and
7 the financial market. In our analysis we find that financial market growth in the UK is
8 governed to a greater extent by the macro-economic climate rather than changes in
9 (Common) law. There might be two main reasons for this. Firstly the 'comply or
10 explain' regime in UK along with an impactful rule of law makes corporate governance
11 easy to implement - but makes it more difficult to facilitate for any perceptible change
12 in the culture of the financial market. Consequently we argue against the 'law matters'
13 hypothesis. Secondly, the UK being a global hub of financial market reacts more to
14 vagaries of global financial movements rather than changes or reforms in the light
15 touch of respective domestic regulations.
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21 **Corporate Governance Reform**

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23 In 1999 the OECD issued their 'Principles of Corporate Governance' (revised 2004),
24 after wide consultation with national governments, the private sector, International
25 Banks etc. The OECD Principles represent common characteristics recognised as
26 necessary for good corporate governance and share commonality with our own
27 internal framework over a range of areas. However, the key point of divergence
28 relates to Principle IV, which focuses specifically on the role of stakeholders in
29 corporate governance. The OECD highlight their preference for corporate governance
30 models to recognise the rights of stakeholders, and 'encourage active co-operation
31 between corporations and stakeholders in creating wealth, jobs, and the sustainability
32 of financially sound enterprises'. To a certain extent it might be suggested that s309
33 Companies Act 1985, and s172 Companies Act 2006 represent significant movement
34 in the direction of stakeholder values, however, as indicated above, the categories of
35 stakeholder indicated in both Acts of Parliament remain secondary considerations for
36 the board, who are only required to consider them to the extent that they 'consider(s),
37 in good faith... most likely to promote the success of the company for the benefit of
38 its members as a whole...'. In addition, the limited opportunity to challenge directors
39 in relation to s309 (1985) and s172 (2006), may lead us to consider that although
40 stakeholder interests may be advertised in the corporate 'window', they are not for
41 sale in the corporate 'shop'.
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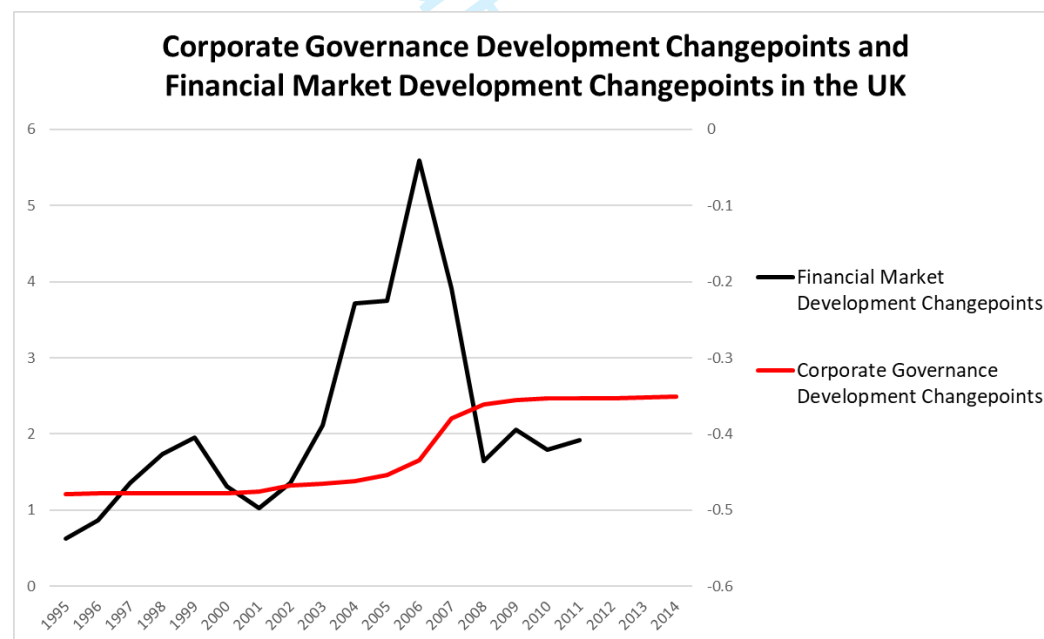
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52 It follows that the current position would therefore suggest that any move towards
53 convergence with the OECD principles, or harmonisation in EU terms has, until now
54 been limited. Interestingly, however, in the aftermath of the Brexit vote on 23rd June
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57 ⁵⁰ Robert Winnett, 'Financial crisis: London stock exchange suffers worst fall in history' *The*
58 *Telegraph* (London, 6 October 2008)
59 <<http://www.telegraph.co.uk/finance/financialcrisis/3147764/Financial-crisis-London-stock-exchange-suffers-worst-fall-in-history.html>>
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2016, we have seen a greater interest in the incorporation of stakeholder values into the UK corporate governance framework. In particular, the Green Paper on Corporate Governance Reform, published in November 2016 states the purpose of corporate governance being to 'facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of a company' adding that 'A key element is protecting the interests of shareholders where they are distant from the directors running a company. It also involves having regard to the interests of employees, customers, suppliers and others with direct interest in the performance of a company'.

Contextualising Corporate Governance and Financial Market Development Change Points

In order to visualise the evolution of normative corporate governance change points against the time specific financial market development change points based on our empirical data the two graphs have been merged as illustrated in the following diagram.



The diagram illustrates the combined previously discussed change points. Significantly, it highlights that based on our empirical data we find that financial market development and financial market growth appear to bear little correlation to significant change points in normative corporate governance development. This provides empirical evidence for our argument against the 'law matters' hypothesis and further distinguishes this view, supporting our hypothesis and positing that several historical and economic reasons in conjunction with a robust rule of law in the UK contributed to the development of a strong financial UK market, and the law especially the type or tilt is less relevant.

Conclusion

In mapping the normative development of UK corporate governance between the years 1995 and 2014, we have undertaken the first longitudinal empirical study of its kind advancing and refining the conception of UK corporate governance evolution. The specific change points used for this analysis have been contextualised against the background of UK financial market development and financial market growth. However, we found no statistically relevant empirical evidence pertaining to changes in corporate governance and the financial market, and therefore conclude that there is little correlation between the two. Instead, we argue that changes in UK financial market development and financial market growth up until this point can be explained rather by a combination of other factors. However, notable changes, such as reforms in the UK corporate governance framework, relating to a greater interest in the incorporation of stakeholder values might paint a different picture. Thus, interestingly, in 2017, in terms of its corporate governance legal framework, the UK finds itself in a somewhat paradoxical situation. Whilst it is on the cusp of political *divergence* from its closest trading neighbours (the EU), at the same time it may be closer to the concept of *convergence* of corporate governance ideas now than it has been at any point in the past.