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Assessing Corporate Governance and the London Stock Exchange: A Historical Analysis

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Introduction

In recent years much debate has centred on corporate governance. The *modus operandi* of the United Kingdom's form of corporate governance is more of reactive than proactive. This reactive stance has serious repercussions for the London Stock Exchange (LSE) as it hosts the listing platform for public companies and the FTSE100. It is thus essential for the LSE that corporate governance procedures work as it needs to ensure that the investor has confidence and trust in it's listings. A weak corporate governance system coupled with corporate malfeasances from the Exchange's members inevitably fails to instil investor confidence. The LSE needs to convince its existing clientele and would be investors that it can run its affairs with proper conduct and integrity. A nervous investor is unhealthy for any business system. The LSE is one of the leading stock exchange markets in the world and is the financial nerve centre of the United Kingdom as it forms the very nucleus of the 'square mile'. According to the LSE it 'serves to ensure that orderly markets are in place through rules, guidance and monitoring of trading and market activity and the exchange's primary aim is to provide issuers, intermediaries and investors with attractive well regulated markets in which to raise capital and fulfil investment and trading requirements' (www.londonstockexchange.com).

This paper aims to highlight the impact of corporate governance upon the LSE. This paper will be split into three sections. First this short paper outlines the history of the LSE and identifies embryonic corporate governance procedure. In this way the paper uncovers factors in the present LSE that can be traced to its inception in terms of governance procedures and fair trading. Second, it provides a definition of corporate governance and investigates change to procedures in the late twentieth century. Finally, through an analysis of the on going reports relating to corporate governance and interactions between the LSE and Financial Services Authority (FSA) the historical nature of the relationship between the LSE and corporate governance is made explicit.

Corporate Governance and the London Stock Exchange: Early Relationships

Beckett (2002) traced the origins of the LSE to 1760 when 150 stockbrokers, expelled from the Royal Exchange for rowdiness, formed a club at Jonathan's Coffee House to buy and sell shares. Subsequently, in 1773 its membership voted to change the name from Jonathan's Coffee House to the Stock Exchange. In order to discourage, what the established professionals called the 'riff-raff', the tinkers and other parasites, a sum of six pence was charged as entrance fee a day (Chapman, 1998; p 19). Thus in the two hundred year history, the Stock Exchange has more or less conformed to some form of governance. The sum of six pence was meant to govern the individual professionals from what the latter called 'riff-raff', the tinkers and other parasites. This was one of the early attempts by the Exchange to maintain an orderly market. However, it was not until March 1801 that the LSE became officially regulated. In January 1801 the 'Committee of Proprietors', representing those who owned the Stock Exchange building, suggested that it should be converted into a Subscription Room (Michie, 2001). According to Michie (2001) 'they proposed that the Subscription Room would have a minimum of 200 subscribers each paying a sum of ten guineas per year. This was to fund the day to day running of the Stock Exchange and also to regulate how the business was to be done. Adherence to these rules and regulations were monitored and adjudicated by a committee, including full time staff, and enforced by threat of expulsion from the market' (ibid, p 35). This self appointment by the Exchange as a regulator of financial markets marked its beginnings as a self regulatory organisation.

One may argue, that even although the term 'corporate governance' was not in existence in existence in the early 19th Century, some form of governance was practised e.g. the daily charge of six pence, the opening of the Subscription Room and the Committee. However, this form of corporate governance was used as a discriminatory tool in the sense that the six pence daily charge was meant to discourage what the professionals viewed as the low life, and the annual subscription of ten guineas meant that only the privileged few could afford to become subscribers. Furthermore, membership was mostly given to applicants whom the Exchange perceived as gentlemen of good repute and those who had the grace of privileged upbringing. In the early days of the LSE, corporate governance was more or less focused on individual members and small entities, whereas today, corporate governance encompasses public listed companies.

In the embryonic LSE, there was less regulation and more emphasis on gentlemen attributes where a gentleman's word was his bond. This provides a binding thread in the sense that throughout its history, the Exchange has always been reluctant to adopt a hard stance toward the deviant members. This is partly a result of the Exchange's habit of running its business in the fashion of a gentlemen's private club. Hence with a private gentlemen's club the naming and shaming of the offenders is deemed harsh enough let alone the threat of expulsion. This has similar themes with Cadbury's Report

recommendations on the naming and shaming the offenders, which was deemed a deterrent against market misconduct.

The Big Bang: the LSE and the 20th Century

As noted above, for over 200 years prior to the Big Bang the LSE operated on the basis of a gentleman's club. It had been owned by its members, who in order to avoid competition, operated a system of minimum commission on all stock transactions (Blake, 1990). As a result of the Big Bang (1986) the Exchange was deregulated with the abolition of minimum commission, the ownership of member firms by an outside corporation was allowed and the single capacity system abolished (Wood, 1988). It can be argued that the Big Bang reforms destabilised the Exchange's system of self-regulation and governance in a closed market. For, with the opening up of the markets and the boom that followed, the Exchange was unable to regulate the markets. The Big Bang brought about an unprecedented boom in financial markets in the City. As money rolled into the City, the traditional values of the Stock Exchange were lost in the buying frenzy that ensued. Consequently, the Exchange failed to tackle the rampant cases of insider dealing, market abuses and regulatory offences. It can be argued, that greed ruled the stock market and this changed its' traditional values.

Prior to the Big Bang deregulation reforms, the Stock Exchange had attempted to informally maintain gentile behaviour amongst its members by its closed door policy and mostly admitting membership to applicants whom it perceived trustworthy. After the Big Bang, it was powerless to act on this basis as it had lost most of its powers to the two new regulation systems that were put in place. Through the instigation of the Cadbury, Greenbury and other corporate governance reports, it sought to inspire integrity within its members by adopting the reports' recommendations as part of listing requirements. Hence, there is a convergence of the traditional values of the Stock Exchange and that of Corporate Governance; to promote high standards of corporate behaviour. The old pre-Big Bang LSE believed that that gentility was traditionally a hereditary merit for the elite whereas it can be argued the post Big Bang corporate governance believed that gentility can also be achieved through the Cadbury Report's recommendations for best practice of corporate behaviour.

The Hampel Committee and its predecessors were private sector initiatives, which arguably served the individual interests of the private sector including those of the Stock Exchange. It is ironic that the Stock Exchange actively participated in these committees including providing funding but was reluctant to be more robust in passing judgement on non-compliance. The Exchange had published a circular dated 8 July 1993 stipulating that the 'Exchange does not see it as part of its role to pass judgment on whether the extent of a company's compliance with the Code is adequate or not, but it may make public any company's failure to make there required statement' (Maw *et al* (1994; p 165). This naming and shaming of would be offenders reflected the old fashioned values of the Exchange; of relying on a gentleman's word/

agreement which meant taking the word of a gentleman in good faith as a binding contract without official sanctions. This is echoed in the Exchange's motto; "*Dictum meum pactum*"- my word is my bond" (ibid).

Corporate Governance: the LSE and the Necessity of Change

Modern corporate governance can be defined as the organisation and monitoring of relationships between owners and the managers in control of a corporation. Steinberg (2000) defined corporate governance as '*referring simply to the need for, and ensuring that the corporation is pursuing its proper ends, typically by keeping the directors accountable to their shareholders'* (p61). The Cadbury, Greenbury, Hampel, Turnbull Reports and the Combined Code (Supercode) arose largely to the high profile corporate failures in the United Kingdom, notably the Robert Maxwell- Daily Mirror scandal and the collapse of the BCCI. These reports advocated self- regulation to ensure that investors were adequately protected without inhibiting the market forces as the then climate had encouraged "opportunism" to prosper (Dunlop, 1994; p4). Mills (1997) was of the view that '*the lax accounting framework which characterized corporate UK in the 1980's and early 1990's seemed to encourage the window dressing of corporate accounts. It was relatively straightforward to disguise company problems of performance and liquidity without there being any legal repercussions' (p 122).* However the reports have no legislative powers and do not apply to private companies. As counter-measures against the legislative deficit, after the publication of the Greenbury Code, the LSE introduced Listing Rule 12.43 (x) which requires all companies to comply with the Code's requirements and to disclose reasons for non compliance to any part of the code. Michie (2001) defines a Stock exchange as *'A market of where specialized intermediaries buy and sell securities under a common set of rules and regulations through a closed system dedicated to that purpose. It is only when all those criteria are met can it be said that a stock exchange has come into existence'* (p 3).

Sir Nicholas Goodison (Chairman, London Stock Exchange, 1976-88) argued that the future of the Stock Exchange remained uncertain. It had lost much of its regulatory role, including the regulation of the relationships of its members with their clients and, more remarkably the regulation of the qualifications and the capital adequacy of its on members (Michie, 2001; p viii). According to Sir Nicholas Goodison the LSE was no longer a provider of settlement services, and needed a regulatory role in order to demonstrate to its members and their customers that it adds value to the market place (ibid). 'It is important therefore, that the Exchange has so far retained its role as the listing authority in the United Kingdom (and is recognized as such under European legislation), and maintains its role in the enforcement of market rules. These roles are at risk as the Financial Services and Markets Act 2000 enabled the FSA to assume its powers as the chief regulatory authority' (ibid, author's brackets). It can be argued, that the London Stock Exchange employs the Combined Code as its regulatory arm in the matters of corporate governance. However, compliance to the Combined Code still remains flexible whereas it is mandatory for the Listing Rules. The Listing Rules ensure that the Stock

Exchange maintains an orderly stock market whereas corporate governance ensures that the Exchange' members run their corporate entities in an orderly, fair and transparent manner. Corporate governance arguably stands as a checklist. Whereas in the past admission to the LSE was upon recommendation of the then existing members; where gentlemen of good repute and standing were favoured. It is now a different form of corporate governance that acts as a good measure and acts as a substitute for the old criterion for membership. The Big Bang reforms made the admission to be a member an open door policy. Corporate governance and the Listing Rules demarcate the eligible from the non eligible. Compliance to the Code still remains voluntary. This runs parallel to the theme that gentility and integrity cannot be legislated. It can be argued, that this is the reason why the LSE is still carries the spirit of a voluntary approach regarding compliance to the Combined Code. Gentility can be instilled through ethics. Ethics should be taught across the boardrooms. In essence, ethical awareness will strengthen corporate governance as it is still deficient of the legislative powers. It is tragic that ethics has not gathered the same speed and momentum as corporate governance has in the United Kingdom.

Owen Green, the former chairman of BTR, asserted that however good its intentions, a mere code cannot inculcate self-discipline into a generation of high-earning go getters who were caught up in the free-market euphoria of the Thatcher years but missed out on Adam Smith's moral teachings (Morris, 1995; p49). Furthermore, according to Robinson (2002) 'the capacity of investors to sell their shares has led to charges that the market for the shares is characterized by 'short-termism' and yet an excess loyalty from the shareholders may mean that they remain supine while their agents destroy long –term shareholder through inappropriate decision making and poor management' The scandals of Enron and WorldCom magnitude have not yet occurred in the United Kingdom. However lessons can be drawn. The UK's Company Law shares some similarities with the United States' Company Law in the sense that both of the Company Law's do not bar auditors from performing non auditing services for the same company. This arguable compromises the traditional role of auditors as independent financial watchdogs.

De Lacy (2002) acknowledged that one size of governance systems does not fit all companies. Any single set of rules might be right for many companies, but will still be both under and over inclusive. Some rules might fail to demand enough of some directors, and yet demand too much of others. Hence it is argued that the Combined Code must be flexible enough to accommodate different sizes and types of companies. Legislation of the Combined Code might arguable be the way forward as the voluntary approach has been less effective. According to DeLacy (2002) 'the increasing involvement in corporate governance by the State through the updating of the Combined Code by the Steering Group Committee mirrors the argument that self regulation is not effective enough. This State appointed Committee is ultimately accountable to Parliament, involves a level of accountability, which the Hampel Committee and its predecessors lacked. However critics of legislation argue that centralisation and government regulation, by contrast are seen as a

bludgeoning, lumbering creature. 'It knows too little too late, about the industry practices it is seeking to control, it regulates all alike, and is slow to respond' (ibid, p 196). Legislation which arguably interferes with the *Laissez faire* economy has to achieve a sort of a balancing act with self regulation. It is a difficult balancing act for the State to juggle with. Personal integrity cannot be legislated but can be instilled. Legislation might get rid of the symptoms but it is not the necessary cure.

In December 2001, the Financial Services Authority (FSA) assumed its powers under the Financial Services and Markets Act 2000 (Morris *et al,* 2001; p1). This Act establishes the FSA as the UK financial services regulator, with the power to issue rules and guidance across the financial services industry. The FSA's Listing Rules came into force in their current form on 1 May 2000 on the transfer of the UK Listing Authority from the London Stock Exchange to the FSA (Williams *et al* 2001/2002; p1). The Listing Rules also reflect that requirements that are mandatory under the European Community Directives (ibid). The FSA Listing Rules also contain provisions designed to encourage observance by listed companies of the Combined Code which sets out the principles of good governance and Code of Best Practice derived from the Hampel, Cadbury and Greenbury Reports (Blair *et al* 2001; p 109). The FSA, like the Stock Exchange, encourages observance of the Combined Code through the Listing Rules. It can be argued that the monitoring of corporate governance and compliance may now be compromised as the FSA does not regulate the Exchange alone, but the financial services industry as a whole, whereas with the old system, the implementation, monitoring of corporate governance fell under the chief sole authority of Exchange.

Conclusion

Corporate governance procedures that identified the birth of the LSE eventually become necessary for business in general and historical evidence relating to corporate governance procedures for business from the early 19th Century to the present time. This relationship between corporate governance and the LSE is further clarified by the Cadbury Report which was as largely due to the Exchange's initiation. Additionally, a direct relationship with Exchange was born as the Cadbury Committee's remit and terms of reference were specifically made towards companies listed on the Exchange. It may be argued, that through historical circumstance any fundamental shifts in corporate governance have a direct bearing on the Stock Exchange as it is the chief regulatory platform for the former. This is in contrast to the FSA which adopted the Combined Code and annexed it as part of the Listing Rules requirements.

Corporate governance and the LSE are historically interlinked and can be traced to March 1801 when the latter was converted into a subscription room and rules and regulations being put in place. These formal rules, compliance procedures and standard operating procedures governing the LSE were further strengthened when the first rule book was commissioned by 'The Committee for General Purposes' in February 1812 as a response to the scandals of the day. These rules, just like the present form of corporate governance were an attempt by the Exchange to instil and uphold gentleman behaviour and integrity within its members. No such historical relationship exists between the FSA and corporate governance as the latter came into existence recently as a result of Government legislation. It is a premature relationship at its infancy and as such cannot at present propel itself forward to that gravity of mutual identity that is also symbolic for the Exchange and corporate governance. Indeed, the historical roots of the FSA also need to be investigated but this short article is not the place for this.

History is a common thread that runs through the veins and binds human beings and entities together. In this sense, it is history that binds the Exchange and corporate governance and as such forms a common nucleus of identity for the two entities. What also anchors and fosters this common identity is that the two entities promote gentility, integrity, morality and professionalism in the conduct of business affairs.

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