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## A study of the incidence and independence of nomination committees

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**Abstract:** The purpose of this study is to understand the factors influencing the adoption and independence of nomination committees. Previous literature identifies potential substitutability and complementarity between corporate governance arrangements that may be beneficial from the perspective of outsiders (e.g., Rediker and Seth, 1995), but our work suggests that similar complementarities may be identified from the perspective of firm insiders. Probit analysis of data from the annual reports of UK public companies from 1998 through 2002 reveals that the shareholdings of substantial shareholders are positively related to the selection of non-executive members to the nomination committee, but that these shareholdings are negatively related to the use of nomination committees in the first place. Coupled with the participation of over 40% of UK CEOs on the appointment committees of their own firms, these results suggest that some appointment committees are used to limit the influence of substantial shareholders on future board appointments.

**Keywords:** boards of directors; nomination committee; demographics and composition; agency theory; corporate governance.

**Reference** to this paper should be made as follows: Cheng, S. and Rayton, B.A. (2012) 'A study of the incidence and independence of nomination committees', *Int. J. Corporate Governance*, Vol. 3, No. 1, pp.84–104.

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## **1 Introduction**

This study analyses the nomination committees in non-financial companies listed in the UK to assess the influences of the boards of directors and substantial investors on the incidence and structure of nomination committees. The nomination committee is one of the main subcommittees of the Board of Directors recommended by successive corporate governance reforms in the UK. It is regarded by the architects of these reforms as important to the formation of a good management team.

The Cadbury Report (1992) recommended that the boards of UK companies delegate their major functions to various sub-committees. This step has been a major focus of successive reviews, including the Hampel Report (1998) and the Higgs Report (2003). The adoption of main board subcommittees: mainly audit committees, remuneration committees and nomination (or appointment) committees; is one of the key corporate governance recommendations for quoted companies. The governance reports have placed differing emphases on the individual board committees, and the resulting guidelines are not identical. Few studies have examined the appointment process in UK corporate boards, but the existing research has all reported a relatively low adoption rate for nomination committees (Conyon, 1994; Conyon and Mallin, 1997; Rayton and Cheng, 2009).

Nomination committee is an essential element in corporate governance structuring. The combination and competence of directors determine a board's effectiveness and the quality of appointment process might have a far-reaching consequence. The Enron scandal illustrates this line of argument. More than 20 members in the top leadership, including chairman, president and chief financial officer were convicted of fraud, conspiracy and other crime. In the USA, the Subcommittee on Investigations by Senate pointed out that the Enron Board of Directors failed to safeguard its shareholders and contributed to the collapse of the company (Report of Permanent Subcommittee on Investigations, P.3). In the UK, the government launched an inquiry into the role of non-executive directors in response to the expressions of public concern (The Higgs Report).

The nomination committee is intended to lead the process for Board and Chief Executive Officer (CEO) appointments (The Higgs Report, para 10.9), and is positioned as a gatekeeper safeguarding the competence of the board and its sub-committees. The intention is to ensure that the board has the ability and autonomy to discharge its responsibilities. Like the adoption of audit and remuneration committees, the adoption of a nomination committee is recommended as good governance practice (The Hampel Report, para 2.7 and 3.19), but UK companies have been slow to adopt nomination committees relative to audit and remuneration committees. While UK companies are regarded to operate under the best corporate governance standards (Anonymous, Mar 2004), the delays in the adoption of nomination committees are noteworthy. Conyon and Mallin (1997) compared the adoption rate of the committee in the UK with that in the USA. They commented on this phenomenon as a distinct failure in the UK corporate governance system. Previous research also shows that the proportion of CEOs serving on the nomination committee in 2002 is higher (at 42.5%) than for audit committees (0.27%) and remuneration committees (1.90%) (Rayton and Cheng, 2009). This involvement calls into question the independence of the board.

In this paper, we review the role and the development of the nomination committee since the Cadbury Report (1992) and examine empirically the different influences on it by employing UK data from 1998 through 2002. Section 2 describes the typical nomination process in the UK, as well as developments in the use of nomination committees since 1992. Section 3 is a brief review of the relevant literature, and Section 4 outlines the research design and methodology. The results are then presented and discussed in Sections 5 and 6 respectively. We draw some conclusions in the final section of the paper.

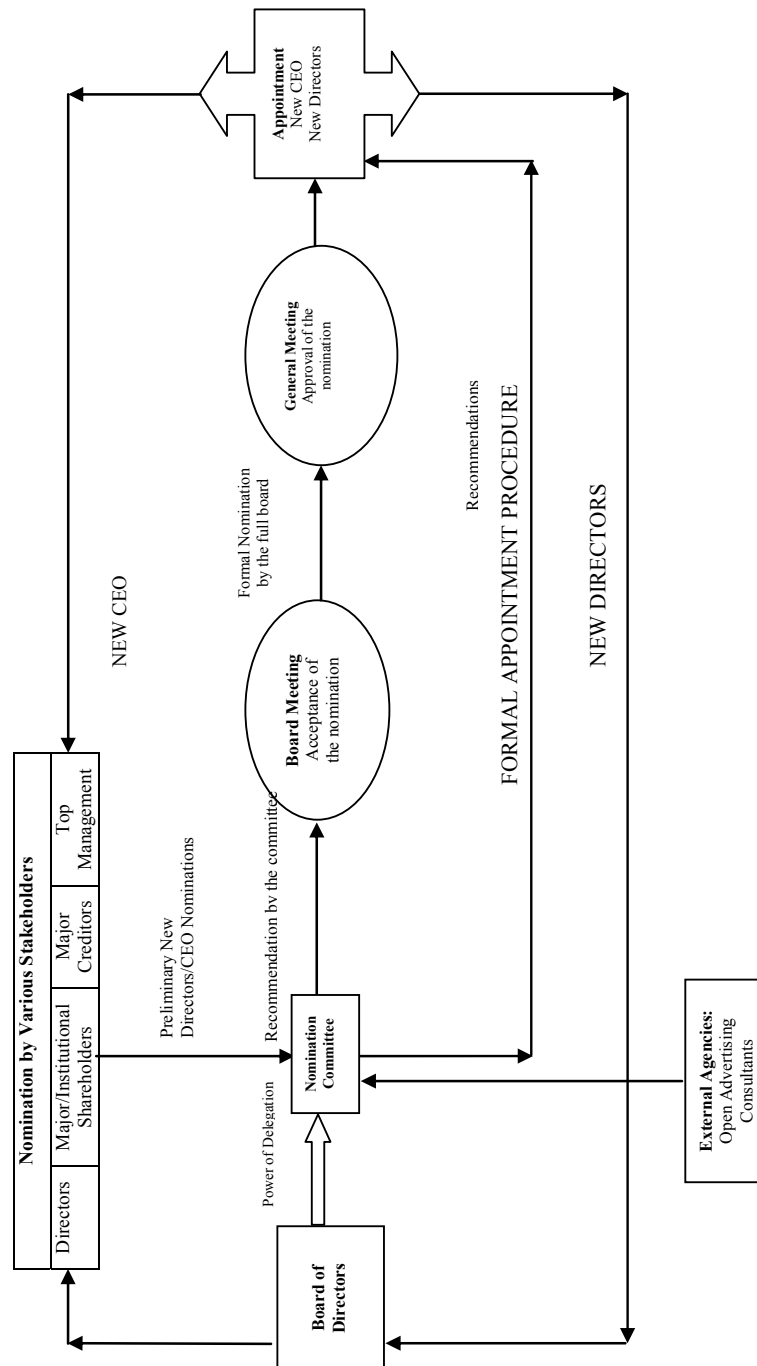
## **2 Nomination committees**

### *2.1 The nomination and appointment process*

Figure 1 illustrates the usual approach to the nomination and appointment process in the UK. The main board typically delegates the power and responsibility for all new board or CEO appointments to an ad-hoc committee, called the nomination or appointment committee. The current UK governance system recommends that this committee have a majority of independent non-executive directors and that the CEO not serve on this committee, though the Chairman may serve on this committee for all matters not involving the selection of a new Chairman. Whenever a vacancy arises on the board, the committee prepares a description of the role and capabilities desired from a new appointee, taking the balance of skills already available on the board into account. The committee considers nominations from stakeholders of the company, such as institutional investors, substantial shareholders, major creditors, incumbent directors and top management; as well as recommendations from professional consultants and open recruitment. This process results in a shortlist of potential candidates which is submitted to the committee. The final recommendation from the committee is then endorsed by the full board, and a formal nomination is made for approval by the shareholders in a forthcoming general meeting. Finally, a formal letter of appointment is sent to the appointee (The Higgs Report, para 10.9). Companies are expected to explain deviations from recommended practice. Examples of such deviations might be the absence of external advice in the process, or a lack of open advertising. In addition to the appointment process, the committee is expected to review the performance of non-executive directors on a regular basis (The Code, para 4.7).

The important thing to note from this discussion is that nominations are a recursive process. The existing board of directors determines the formation and structure of the nomination committee, and this committee will then nominate new members to the board of directors. This new board will perform the same process in succeeding years. The dynamic nature of this relationship provides an important context for empirical work examining the structure of boards and sub-committees.

**Figure 1** Visual summary of the nomination process suggested by the UK corporate governance system



## *2.2 The development of nomination committees since 1992*

Ownership and management are separated in the contemporary corporate system. This separation between ownership and control is the subject of a large body of agency theory research (e.g., Jensen and Meckling, 1976). At the centre of this literature is the recognition that shareholders and executives often have different objectives, and the assumption that these actors seek to maximise their own welfare. This conflict of interests can induce agency problems that could contribute to the onset of corporate crises. The BCCI and Maxwell collapses in the UK, and the Enron and WorldCom scandals in the USA are often cited as examples of this phenomenon (Boyett and Ward, 1999; Walter, 2004; Arnold and Lange, 2004; Health and Norman, 2004; Cheng and Firth, 2005).

The Cadbury Committee was established in 1991 to study the financial aspects of UK corporate governance. This was a response to public concern over several significant corporate failures in the late 1980s. The Cadbury Report and the resulting Code of Best Practice were published in December 1992. These publications recommended that companies delegate principal functions to an audit committee (para 4.35), remuneration committee (para 4.42) and nomination committee (para 4.30). Cadbury proposed that the nomination committee, “should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director” (The Cadbury Report, para 4.30), but this recommendation was not embedded in the resulting Code of Best Practice.

The Hampel Committee was set up to review the substance and implementation of the Cadbury and Greenbury Codes. The Report was published in January 1998 and suggested that, “Companies should set up a nomination committee to make recommendations to the board on all new board appointments” (The Hampel Summary, para 16). The Stock Exchange issued The Combined Code to provide some prescriptive provisions on structuring a sound governance system in June 1998. The Code said that, “A majority of the members of [the nomination committee] should be non-executive directors”, but excused small boards from establishing a nomination committee (The Combined Code, para A.5.1).

The corporate scandals that occurred in the USA in late 2001 aroused anxiety about the efficacy of the UK corporate governance system. The Higgs Committee was charged with studying the roles and the effectiveness of non-executive directors, and its report, issued in January 2003, placed more emphasis on the appointment process for new directors. The Higgs Report proposed increases in the transparency of the board nomination and appointment process. In particular, the Report suggested that all listed companies should have a nomination committee consisting of a majority of independent non-executive directors, and that the chairman of the board should not chair the nomination committee (The Higgs Report, para 10.9). The proposals of the Higgs Report were only partially adopted in the resulting New Combined Code, as the latter recommendation seemed to imply a lack of confidence in the chairman. The New Combined Code only suggests that, “A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive directors should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship” (New Combined Code, para A.4.1).

**Table 1** Major recommendations of the governance reports on nomination, audit and remunerations committees

<i>Reports</i>	<i>Nomination committee</i>	<i>Audit committee</i>	<i>Remuneration committee</i>
Cadbury (1992)	<ul style="list-style-type: none"> <li>• The members should mainly be non-executive directors</li> <li>• Chaired by the chairman or a non-executive director (not included in the resulting Code)</li> <li>• NA</li> </ul>	<ul style="list-style-type: none"> <li>• Should be established by all listed companies</li> <li>• At least 3 members who are confined to non-executive directors</li> <li>• NA</li> </ul>	<ul style="list-style-type: none"> <li>• Members should wholly or mainly be non-executive directors</li> <li>• Chaired by non-executive director</li> <li>• Members should wholly be non-executive directors</li> <li>• At least 3 members and 2 in the case of small companies</li> <li>• Support the Cadbury and Greenbury recommendations</li> <li>• Companies should establish a remuneration committee</li> <li>• Members should wholly be independent non-executive directors</li> <li>• Directors should not participate in their own remuneration decision</li> <li>• The board should set up remuneration committee of independent non-executive directors</li> </ul>
Greenbury (1995)	<ul style="list-style-type: none"> <li>• NA</li> </ul>	<ul style="list-style-type: none"> <li>• NA</li> </ul>	<ul style="list-style-type: none"> <li>• Members should wholly be non-executive directors</li> <li>• At least 3 members and 2 in the case of small companies</li> <li>• Support the Cadbury and Greenbury recommendations</li> <li>• Companies should establish a remuneration committee</li> <li>• Members should wholly be independent non-executive directors</li> <li>• Directors should not participate in their own remuneration decision</li> <li>• The board should set up remuneration committee of independent non-executive directors</li> </ul>
Hampel (1998)	<ul style="list-style-type: none"> <li>• There should be formal and transparent procedure for the appointment of new directors</li> <li>• A nomination committee should be recognized as good practice</li> </ul>	<ul style="list-style-type: none"> <li>• Support the Cadbury recommendation</li> <li>• All companies should have an audit committee</li> <li>• At least 3 non-executive directors of which 2 are independent</li> </ul>	<ul style="list-style-type: none"> <li>• Support the Cadbury and Greenbury recommendations</li> <li>• Companies should establish a remuneration committee</li> <li>• Members should wholly be independent non-executive directors</li> <li>• Directors should not participate in their own remuneration decision</li> <li>• The board should set up remuneration committee of independent non-executive directors</li> </ul>
Combined code (1998)	<ul style="list-style-type: none"> <li>• Unless the board is small, a nomination committee should exist</li> <li>• A majority of the members should be non-executive directors</li> <li>• Chairman should be either chairman of the board or a non-executive director</li> </ul>	<ul style="list-style-type: none"> <li>• The board should establish an audit committee</li> <li>• A least 3 members, all non-executive directors.</li> <li>• A majority should be independent</li> </ul>	<ul style="list-style-type: none"> <li>• The board should set up remuneration committee of independent non-executive directors</li> </ul>

**Table 1** Major recommendations of the governance reports on nomination, audit and remunerations committees (continued)

<i>Reports</i>	<i>Nomination committee</i>	<i>Audit committee</i>	<i>Remuneration committee</i>
Smith (2003)	<ul style="list-style-type: none"> <li>• NA</li> </ul>	<ul style="list-style-type: none"> <li>• A least 3 members who are confined to independent non-executive directors</li> <li>• At least 1 member should have significant, recent and relevant financial experience</li> <li>• Chairman of the company should not sit on the committee</li> </ul>	<ul style="list-style-type: none"> <li>• NA</li> </ul>
Higgs (2003)	<ul style="list-style-type: none"> <li>• All listed companies should have a nomination committee</li> <li>• Majority of independent non-executive directors</li> <li>• Chairman should not chair the committee at all</li> </ul>	<ul style="list-style-type: none"> <li>• The board should establish an audit committee</li> <li>• A least 3 members who should all be independent non-executive directors</li> <li>• At least 1 member should have significant, recent and relevant financial experience</li> </ul>	<ul style="list-style-type: none"> <li>• Consist of at least 3 members</li> <li>• Membership is exclusively of independent non-executive directors</li> </ul>
Revised code (2003)	<ul style="list-style-type: none"> <li>• There should be a nomination committee</li> <li>• A majority of members should be independent non-executive directors</li> <li>• Chairman or an independent non-executive director should chair the committee</li> <li>• The chairman should not chair when it is dealing with the appointment of successor to the chairmanship</li> </ul>	<ul style="list-style-type: none"> <li>• The board should establish an audit committee</li> <li>• At least 3, or in the case of smaller companies (i.e. below FTSE 350), 2 members, who should all be independent non-executive directors.</li> <li>• At least 1 member has significant, recent and relevant financial experience</li> </ul>	<ul style="list-style-type: none"> <li>• The board should establish a remuneration committee</li> <li>• At least 3, or in the case of smaller companies (i.e. below the FTSE 350) 2, members, who should all be independent.</li> </ul>

Table 1 summarises the changes in the recommendations for the structures of key committees since the Cadbury Report (1992). It is clear that the audit and remuneration committees have received more attention than the nomination committee. For example, there have been two independent Committees, Greenbury (1995) and Smith (2003), charged with the exclusive study of the remuneration committee and the audit committee. Also, the Combined Code of 1998 granted an exemption from nomination committees to small boards, and the Revised New Combined Code (2003) regards the nomination committee as the only committee on which not all members are required to be independent. The resulting picture is one where nomination committees are consistently regarded as important by successive governance reports, but the entrenchment of these views in the code and the use of nomination committees in practice both appear to be considerably delayed by comparison with changes to the status and use of remuneration and audit committees.

### **3 Literature review**

Many academics have affirmed the significance and advantages of nomination committees (O'Neal and Thomas, 1995; Conyon and Mallin, 1997; Carson, 2002). The collective picture presented by this work is one in which the nomination committee improves meritocracy in appointments, fosters independence on the board, and consequently improves control over managerial discretion. Statistics from previous studies have revealed an increased prevalence of nomination committees over the past ten years, but the levels of compliance with the recommendations surrounding nomination committees by UK firms has been considerably lower than for remuneration and audit committees. As such, a study of the factors governing the adoption and composition of nomination committees can provide important insights into the system of corporate governance in the UK. There has been much discussion about board committees (Conyon, 1994; Conyon and Mallin, 1997; Dahya et al., 2002; Carson, 2002; Dedman, 2002) since the publication of the Cadbury Report (1992), and the majority of this work focuses on the remuneration and audit committees (Main and Johnston, 1993; Baker and Owsen, 2002; Carcello et al., 2002; Piot, 2004). Comparatively little work has focused on the nomination committee.

The structure of nomination committees is important because this committee acts as a gatekeeper for future board appointments. Existing work suggests that chairmen may have a vested interest in the performance of their own appointments, as poor performance reflects badly on them (Florou, 2005). Many authors discuss the importance of board composition with recent attention around the degree and effects of interlocking of corporate boards (e.g., Ruigrok et al., 2006; Fitch and White, 2005), but Conyon and Muldoon (2006) argue that the degree of interlocking on boards is not higher than would be predicted by a map theory under reasonable assumptions.

Carson (2002) studied the factors associated with the development of board sub-committees in Australia. The results showed that audit committees were highly developed, and that remuneration committees were developing, while nomination committees were relatively immature. For example, only 17% of companies in Carson's study had a nomination committee. The study also reported that the incidence of nomination committees was significantly related to board size and leverage. Carson



also noted that nomination committees dominated by non-executive directors might reduce the influence of management over the appointment process and the ensuing main board.

The Higgs committee claimed, “The nominations and appointments process is crucial to strong corporate performance as well as effective accountability” (para 10.2). Some studies have measured the connection between corporate performance and top management appointments. Dahya et al. (2002) found that management turnover and sensitivity of turnover to firm performance both significantly increased following the adoption of the Cadbury recommendations. They also suggested that the increase in the sensitivity of turnover to performance was the result of an increase in outsiders on the board. Dahya and McConnell (2005) found that the likelihood of an outside CEO appointment was significantly related to the fraction of outside directors on the board, and that the announcement period stock return associated with the appointment of an outsider as CEO was greater than the announcement period stock return associated with the appointment of an insider. Shivdasani and Yermack (1999) studied the influence of the CEO on the appointment of new directors, and reported that stock price reactions to independent director appointments were significantly lower when the CEO was involved in the selection. However, Lin et al. (2003) could not identify a significant abnormal market return during the announcement period of outside director appointments. The above research is consistent with the view that the appointment of external directors and executives is regarded as means of reducing agency problems and potentially improving corporate performance.

Some researchers have examined the nomination committee or the appointment process in their corporate governance studies. O’Neal and Thomas (1995) investigated the strategic role of the board in their research. They interviewed eighteen directors in some for-profit US corporations. Those interviewed insisted that director selection was one of the most critical issues facing boards. The study also demonstrated that individuals serving as both the CEO and Chairman were much more likely to choose the directors. Lasfer (2006) finds evidence that high levels of managerial ownership give the CEO sufficient power to appoint a board that is unlikely to monitor. The literature suggests the existence of significant CEO power in the nomination process. This power is likely to be strongest for those executives who are experienced and may have entrenched their positions. Conyon (1994) carried out a retrospective postal survey to study the change to the nature of governance structures in UK companies. He found that the incidence of nomination committees had trebled between 1988 and 1993, with approximately 39% of quoted companies claiming that they had a nomination committee in 1993. Three other studies also disclosed adoption rates for nomination committees. Conyon and Peck (1998) examined publicly traded UK firms in 1991 and identified only 12% of the sample firms with nomination committees. This figure rose to 72% in 1994. The Cadbury survey (1995) reported that 50% of the 500 listed firms in their study had a nomination committee in 1993/94 compared to 5% in 1991/92. Vafeas and Theodorou (1998) investigated the link between board structure and firm performance and reported that 28% of UK companies used nomination committees, and that 86% of the members of these committees were outsiders in 1994. Rayton and Cheng (2009) reported that the number of companies using a nomination committee doubled between 1993 and 2002, with 84% of companies using nomination committees in 2002, and 80% of the seats filled by non-executive directors.

## **4 Research design**

This section of this paper suggests several hypotheses worthy of investigation in the context of the preceding literature, and describes the data and empirical approaches used to test them.

### *4.1 Hypotheses*

Nomination committees are an important part of the corporate governance system, and their composition has evolved over time. Board vacancies are filled by the nomination committee, and then the new board reconstitutes the nomination committee. Several internal and external forces may be at work in this dynamic process. We hypothesise that the characteristics of the existing board will influence the future structure of the nomination committee. This leads us to hypothesise that:

- H1 The proportion of non-executive directors on the board of directors in the current year is positively associated with the incidence and independence of the nomination committee in the following year.
- H2 The proportion of shares held by the non-executive directors is negatively associated with the incidence and the independence of the nomination committee in the following year.

These two hypotheses capture the influence of the board of directors on the formation and structure of the nomination committee. For example, a board that is dominated by the interests of managers may fill the nomination committee with individuals who are likely to preserve this bias with subsequent appointments. We might also expect that non-executive directors with high levels of share ownership might prefer participation in the appointment process to delegation of these responsibilities in order to safeguard their own interests.

It is likely that the characteristics of institutional investors and other substantial shareholders play an influential part in the selection of new board members. The Cadbury Report (1992) pointed out that institutional shareholders owned the majority of the shares of quoted companies (para 6.9) and were able to influence the standards of corporate governance in these companies (para 6.10). Cadbury encouraged institutional investors to take a positive interest in the composition of boards, and to strive for the appointment of a group of non-executive directors of the necessary caliber, experience and independence (para 6.11). Johnson et al. (1996) noted, "A considerable amount of institutional investor activism is directed at reforming corporate boards".

- H3 The proportion of the shares held by the major external shareholders in the current year is negatively associated with the incidence of the nomination committee in the following year.
- H3a The proportion of the shares held by the major external shareholders in the current year is positively associated with the independence of the nomination committee in the following year.

These hypotheses assess the influence of major shareholders on the composition of the nomination committee. We reason major shareholders are better positioned to monitor

executive actions due to the relatively larger benefits associated with their monitoring activities, and that if these shareholders directly monitor this may diminish the importance of other control mechanisms (Rediker and Seth, 1995; Ruigrok, et al., 2006). It may also be the case that substantial shareholders can exert direct influence on the appointment of new directors through the main board that may be diminished by the delegation of this role to a committee. That said, substantial shareholders would prefer any nomination committee in use to be more independent.

It is important to consider both the number of substantial shareholders and the proportion of the shares these individuals collectively own. As the number of substantial shareholders increases, given the proportion of shares in this block, the absolute power of any individual diminishes. This limits the ability of block shareholders to form coalitions that can influence corporate governance arrangements in their collective interest. This leads us to expect:

- H4 The number of the substantial shareholders in the current year is positively associated with the incidence of the nomination committee in the following year.
- H4a The number of the substantial shareholders in the current year is negatively associated with the independence of the nomination committee in the following year.

Hypotheses H3, H3a, H4 and H4a together predict a sophisticated interaction between the magnitude of the combined shareholdings of substantial shareholders and the number of these individuals. They suggest both a degree of substitutability between institutional arrangements for controlling managerial discretion, as well as difficulties of forming meaningful coalitions amongst larger numbers of substantial shareholders.

## 4.2 Models

Because our dependent variables of interest are coded as binary variables or as proportions, we employ a set of three probit models in the analysis. All of these are based on the same set of independent variables. Our specification allows us to test the influence of the main board and substantial shareholders on the nomination committee in the following year. This dynamic structure allows us to better understand the process through which changes in the nomination committee occur. For convenience, we present the model in terms of the effect of current period independent variables on future values of the dependent variables.

The dependent variables in our probit analyses are:

- 1 the existence of a nomination committee (*Lead\_Nom*)
- 2 The fraction of nomination committee membership who are non-executives (*Lead\_%NonNom*)
- 3 The existence of an in-built majority of non-executive directors on the nomination committee (*Lead\_Majority*).

*Lead\_Nom* is a binary variable taking the value one for companies with a nomination committee and taking the value zero otherwise. *Lead\_%NonNom* and *Lead\_Majority* are both measures of the independence of the appointment committee in the following year. *Lead\_%NonNom* is the proportion of the non-executive directors on the nomination committee while *Lead-Majority* is a binary variable which equals one if the proportion of

non-executive directors on the committee is equal to or greater than 50%, and equals zero otherwise. We examine both variables because the value of non-executive membership may be connected to majority status, rather than being a simple function of the proportion of non-executive members.

Probit models are designed for dealing with binary dependent variables, but it is possible to run these models on data reported as percentages if the observations are weighted appropriately. This approach interprets each fraction (e.g., three out of four members of the nomination committee members in Company X are non-executive directors) as a set of zeros and ones. In the context of this paper, the effect is to change the unit of analysis from the committee to the individual seat on that committee. We use *Lead\_ %NonNom* as a dependent variable, and weight the observations in this model by the number of members of the nomination committee. The coefficients can then be interpreted as relevant to the prediction that any individual seat on a nomination committee will be given to a non-executive director.

The independent variables are categorised into four groups. The first group captures the structure of the board of directors. In this group we include the proportion of the outsiders on the main board (*%NonExe*) in order to test H1. The percentage of outstanding shares owned by the directors, excluding those of the CEO is included in the probit models as *%DirShr*, and the coefficients associated with this variable allow us to test H2. The second group of independent variables describes the substantial shareholders. Consistent with the reporting rules for UK public companies, we define significant shareholders as those who own at least 3% of the company. The number of significant shareholders enters our analyses as *N\_Bl*, while the proportion of company shares held collectively by these shareholders enters our analyses as *%Bl*. The inclusion of these two variables allows us to test our remaining four hypotheses. The final group of independent variables is a set of control variables. We include proxies for executive power in our models including CEO age (*Age*), company tenure (*Tenure*), the separation of the roles of CEO and Chairman (*SepRole*), as well as the proportion of company shares owned by the CEO (*%CEOShr*). We use the logarithm of total sales (*LnSale*) as a control for firm size. We also include year and industry fixed effects in our analyses.

### *4.3 Sample and data*

The data used in this study come primarily from the annual corporate reports of non-financial companies listed on the London Stock Exchange from 1998 to 2002.<sup>1</sup> After excluding companies whose major activities are not based in the UK, there were 843 candidates in the 2002 population. We were unable to obtain some company reports, and some of the reports obtained were ambiguous about some variables of importance to our analyses. We ultimately obtained useful data from 655 firms.

When examining the determinants of the incidence of nomination committees (Model A) we examine data only from companies that did not have nomination committees in 1998. This allows us to focus on the determinants of changes in status. Thus while there are 655 companies available, the data for Model A are drawn from the available firm years contributed by the 317 companies without nomination committees in 1998 (1,442 firm years). When examining the independence of nomination committees (Models B and C) we are limited to the investigation of firm years in which a nomination committee is present (459 firms; 1,632 firm years).

There are two major advantages in scrutinising companies' annual reports for the data. First, annual accounts and reports are accredited documents that proclaim a company's financial situation and corporate information. The data gathered from annual reports is therefore supposed to be authoritative and credible. Such data has certainly passed the scrutiny of the audit process. In this way we avoid the well-documented problems associated with single-respondent survey data.<sup>2</sup> The second advantage of relying on annual reports is that all public companies must file these reports. There is no legal requirement for firms to publish certain governance data (though they would be expected to explain their non-compliance), but our data show that by 1998 over 90% of UK companies chose to fully disclose their governance arrangements. As such, we extract our corporate governance data and our information about CEOs from the annual reports. Data on sales, total assets and the number of outstanding shares are taken from the Datastream database. Industry codes for individual firms come from the London Stock Exchange website.

## 5 Results

Table 2 summarises the descriptive statistics of our sample variables. During the sample period, 60% of the companies operate a nomination committee, and 80% of the members of these committees are non-executive directors. The standard deviations of these variables reveal more variation in the use of the committees than in the use of non-executive members on extant committees.

**Table 2** Summary statistics for dependent and independent variables used in the analyses in this paper

<i>Variable</i>	<i>Definition</i>	<i>Mean</i>	<i>Median</i>	<i>Std.deviation</i>
NomCom	Incidence of nomination committee (binary variable)	0.60	1.00	0.49
%NonNom	Proportion of non-executive directors on Nomination Committee	0.81	0.80	0.17
Majority	Majority (at least 50%) of the nomination committee members are non-executive	0.98	1.00	0.15
%DirShr	Percentage of directors' shareholdings in the company (-CEO holdings)	0.08	0.02	0.13
SepRole	Separation of the role between chairman and CEO	0.83	1.00	0.38
Age	Age of CEO at the end of fiscal year	51.23	52.00	7.11
Tenure	Number of years the CEO has taken up the position in the company	6.61	5.00	6.18
%CEOShr	Percentage of CEO's shareholding in the company	0.05	0.00	0.11
%NonExe	Proportion of non-executive directors on the board of directors	0.48	0.50	0.14
N_Bl	Number of shareholders who own at least 3% of the company's outstanding shares	4.38	4.00	2.47
%Bl	Proportion of shares in the company held by the substantial shareholders	0.32	0.31	0.19
Sale	Total sales for the year (in millions of pounds)	1,303.90	142.36	8,436.97

**Table 3** Correlation matrix of variables based on data from Models B and C (firm years with nomination committees)

<i>Variable</i>	<i>Definition</i>													
NomCom	Incidence of nomination committee in current year (binary variable)													
%NonNom	Proportion of non-executive directors on Nomination Committee in current year													
Majority	Majority (at least 50%) of the nomination committee members are non-executive													
%DirShr	Percentage of directors' shareholdings in the company (-CEO holdings)													
Lead_Nom	Incidence of nomination committee in following year (binary variable)													
Lead_%NonNom	Proportion of non-executive directors on Nomination Committee in following year													
SepRole	Separation of the role between chairman and CEO													
Age	Age of CEO at the end of fiscal year													
Tenure	Number of years the CEO has taken up the position in the company													
%CEOShr	Percentage of CEO's shareholding in the company													
%NonExe	Proportion of non-executive directors on the board of directors													
N_Bl	Number of shareholders who own at least 3% of the company's outstanding shares													
%Blk	Proportion of shares in the company held by the substantial shareholders													
LnSale	Natural logarithm of total sales for the year (in millions of pounds)													
1	NomCom	a	0.06*	-0.25**	0.88**	0.03	0.15**	0.04	-0.14**	-0.23**	0.20**	-0.05**	-0.09**	0.47**
2	%NonNom		0.36**	-0.11**	0.03	0.83**	0.12**	-0.07**	-0.15**	-0.09**	0.26**	0.02	0.10**	-0.02
3	Majority			-0.10**	a	0.47**	0.11**	-0.10**	-0.07**	-0.16**	0.21**	0.00	0.04	0.10
4	%DirShr				-0.23**	-0.09**	0.07**	-0.10**	-0.00	0.17**	-0.17**	-0.19**	-0.21**	-0.29**
5	Lead_Nom					a	0.13**	0.06**	-0.12**	-0.22**	0.19**	-0.08**	-0.11**	0.46**
6	Lead_%NonNom						0.11**	-0.08**	-0.15**	-0.09**	0.23**	0.00	0.08**	0.01
7	SepRole							-0.29**	-0.31**	-0.33**	0.18**	0.04*	0.07**	0.07**
8	Age								0.28**	0.08**	-0.06**	-0.07**	-0.07**	0.14**
9	Tenure									0.36**	-0.18**	-0.02	-0.06**	-0.09**
10	%CEOShr										-0.22**	-0.16**	-0.18**	-0.29**
11	%NonExe											-0.02	0.13**	0.19**
12	N_Bl												0.73**	-0.15**
13	%Blk													-0.20**
14	LnSale													1.00

Notes: a cannot be computed because at least one of the variables is constant

\* correlation is significant at the 0.05 level

\*\* correlation is significant at the 0.01 level

Total board shareholdings (excluding the holdings of the CEO) averages 7.9% of the company with a standard deviation of 13%. This ownership stake is moderate when compared to a figure of 26% in East Asia (Lemmon and Lins, 2003) and the 2.5% in the USA (Coles et al., 2001). The mean percentage of companies separating the role of Chairman and CEO is 83% (standard deviation of 38%). We find that 48% of the members of the typical board of directors are non-executives. These results are similar to figures reported in Dahya et al (2002) and Dedman (2003), both of which find that less than 20% of UK companies combine these roles, and that over 45% of the directors on the main board are outsiders.

CEO shareholdings average 5% in our sample with a standard deviation of 11%. The mean age of the top executives in our sample is 51, and the average CEO has been in the job approximately 6.6 years. The CEO ownership in other studies (Dedman, 2003; Dahya et al., 1998; Coles et al., 2001) ranges from 2.1 to 2.5%, average CEO age is around 51, and average tenure is between 5.9 to 6.9 years.

There are 4.38 significant shareholders in the average company; where (consistent with the London Stock Exchange) we define significant shareholders as those who hold at least 3% of the shares of the company. When the shares of these significant shareholders are combined they typically amount to about one third of the outstanding shares in the company.

Table 3 presents the Pearson correlation matrix for the variables used in Models B and C. The correlations among the independent variables are generally moderate, apart from the correlation between *N\_Bl* and *%Bl*, but this direct relationship is expected. We see evidence of significant autocorrelation in the structure of nomination committees. This is seen in the significant correlations between *NomCom* and *Lead\_Nom*, and *%NonNom* and *Lead\_%NonNom*.

Table 4 reports the results of our probit analyses. The dependent variable in Model A is a dummy variable indicating the presence of a nomination committee (*Lead\_Nom*). In Model B we examine the percentage of the nomination committee members who are non-executives (*Lead\_%NonNom*), and in Model C we examine a dummy variable taking the value of one if the nomination committee has an in-built majority of non-executive directors (*Lead\_Majority*). All of the models exhibit acceptable fit. Models A and B converged within six iterations. Model C converged after 31 iterations. All available diagnostics for Model C are acceptable, and we attribute the lengthy convergence process to the small number of zeros in the dependent variable (40 out of 1,632) rather than unreliability of the model.

Model A shows that the main board has a strong influence on the establishment of a nomination committee. The estimated effect of the proportion of non-executive directors on the board (*%NonExe*) is positive and significant at conventional levels. This means that boards with a higher proportion of non-executive members are more likely to establish a nomination committee in our sample period. We see similarly positive and significant effects when looking at Model B and Model C. These results reflect the importance of non-executive board members in ensuring the independence of the appointment committee. Taken together, these results represent strong support for our first hypothesis.

**Table 4** Results of probit analysis of the future structure of nomination committees in UK firms (one year lead)

Variable	Definition	Model A	Model B	Model C
		Dependent variable: Binary variable equaling 1 if a nomination committee exists at time $t+1$	Dependent variable: Proportion of non-executive membership of the nomination committee at time $t+1$	Dependent variable: Binary variable equaling 1 if there is a majority of non-executives on the nomination committee at time $t+1$
Constant		-5.753*** (-9.916)	0.920*** (4.584)	-3.376** (-2.456)
%NonExe <sub><i>t</i></sub>	Proportion of non-executive directors on the board of directors	0.583** (2.104)	0.804*** (8.018)	3.434*** (4.829)
%DirShr <sub><i>t</i></sub>	Percentage of directors' shareholdings in the company (-CEO holdings)	-0.720*** (-2.600)	-0.578*** (-4.590)	-1.162* (-1.663)
N_Blk <sub><i>t</i></sub>	Number of shareholders who own at least 3% of the company's outstanding shares	0.016 (0.742)	-0.024*** (-2.997)	-0.048 (-0.632)
%Blk <sub><i>t</i></sub>	Proportion of shares in the company held by the substantial shareholders	-0.981*** (-3.169)	0.385*** (3.523)	1.694 (1.494)
Age <sub><i>t</i></sub>	Age of CEO at the end of fiscal year	0.008 (1.562)	-0.002 (-1.162)	-0.028* (-1.956)
Tenure <sub><i>t</i></sub>	Number of years the CEO has taken up the position in the company	-0.023*** (-3.558)	-0.013*** (-5.446)	-0.002 (-0.159)
%CEOShr <sub><i>t</i></sub>	Percentage of CEO's shareholding in the company	0.078 (0.239)	-0.110 (-0.677)	-0.085 (-0.102)
SepRole <sub><i>t</i></sub>	Separation of the role between chairman and CEO	0.150 (1.435)	-0.0002 (-0.005)	0.169 (0.700)
LnSale <sub><i>t</i></sub>	Natural logarithm of total sales for the year (in millions of pounds)	0.269*** (9.905)	-0.012 (-1.474)	0.269*** (4.306)
Industry dummies	Resources, Basic Industry, General Industry, Cyclical Goods, Non-cyclical goods, Cyclical Services, Non-cyclical services, Utilities, IT	Yes	Yes	Yes
Year dummies	1998-2002	Yes	Yes	Yes
Observations		1,442	1,632	1,632
Iterations to convergence		5	6	31
Chi-squared		315.520	270.846	152.769
<i>p</i> value		0.000	0.000	0.000

Notes: Probit coefficients reported with t-statistics in parentheses  
Statistical significance indicated at 10% (\*), 5% (\*\*) and 1% levels (\*\*\*)



The proportion of company shares owned by directors (%DirShr) shows a significant negative relationship with the incidence of nomination committees (Model A) and the independence of individual nomination committee members (Model B). There is weaker evidence of a similar relationship between %DirShr and the existence of an in-built majority on the nomination committee (Model C). Collectively, these results support our second hypothesis.

Hypothesis 3 suggests that share ownership by substantial shareholders operates as another alternative to nomination committees for controlling managerial discretion, and we see clear support for this hypothesis in the estimated effect of %Blk in Model A ( $t = -3.169$ ). We see strong support for our hypothesised link between share ownership by substantial shareholders and the independence of the nomination committee (Hypothesis 3a) in Model B ( $t = 3.523$ ). We see a similarly positive (though insignificant) relationship in Model C ( $t = 1.494$ ).

We are unable to identify a significant link between the number of substantial shareholders and the incidence of a nomination committee in the following year. The estimated coefficient is of the predicted sign, but this cannot be regarded as meaningful support for Hypothesis 4. We find evidence consistent with our predictions for Hypothesis 4a. The estimated coefficients for N\_Blks are negative in Model B and Model C, though only the estimate in Model B is statistically significant ( $t = -2.997$ ).

## 6 Discussion

The board of directors is the control centre of a contemporary public company. Executive directors lead the daily operations of the company following strategies endorsed by the entire board. Non-executive directors safeguard the interests of shareholders by monitoring management actions and corporate performance. The competence, skill and experience of the individual directors and of the board as a whole are essential. The establishment of nomination committees is good governance practice. This paper has sought to discover those factors influencing the formation and independence of nomination committees, and we have identified the influence of the main board and the influence of substantial shareholders as important determinants of these phenomena.

Our results show a robust link between the board of directors and the nomination committee. The findings suggest that an independent board not only tends to delegate its appointment function to a sub-committee, but it is also more likely to give meaningful power to non-executive directors. Perhaps this is unsurprising, as nomination committee members are usually drawn from the main board. Interestingly, greater share ownership by board members decreases the likelihood of establishing a nomination committee. This may be because non-executive directors with large ownership stakes prefer involvement in the appointment process at the main board rather than risking their exclusion from a nomination committee. This is evidence of substitutability between corporate governance arrangements consistent with Rediker and Seth (1995) and Ruigrok et al (2006). Other authors suggest that the exercise of such power by directors who own less than 100% of the shares in a company could create an environment in which majority owners might expropriate assets from minority owners (Cheng and Firth, 2005).

This paper also demonstrates the influential role of substantial shareholders in the governance of public companies. Our results show that increasing ownership by substantial shareholders tends to decrease the probability of the establishment of

nomination committees. Again, this is evidence of substitutability between corporate governance arrangements consistent with Rediker and Seth (1995) and Ruigrok et al (2006). Greater degrees of ownership concentration are thought to lower the relative costs of monitoring by shareholders and decrease the need for other governance arrangements (and their attendant costs). This evidence is also consistent with substantial shareholders who view nomination committees as a mechanism for CEOs to control the appointment process. This point is made stronger by our observation that increasing ownership by substantial shareholders increases the pressure for an independent nomination committee. It is as though these shareholders believe that nomination committees are not as good as direct board control of the appointment function, but that if this committee is going to exist then it should be independent. The power of these substantial shareholders appears to be diluted with the presence of other substantial shareholders, holding the level of their collective holdings constant. This suggests that three substantial shareholders, each owning 8% of the company will be more effective at controlling managerial discretion than six shareholders, each owning 4% of the company. This may reflect the difficulties of forming blocking coalitions amongst larger numbers of substantial shareholders.

## **7 Conclusions**

This study has looked for insight into the nomination and appointment process in UK public companies. We hypothesised that various forces in the current year might influence the governance of the nomination and appointment process in the following year. We have provided evidence that substantial shareholders and boards of directors all have some influence over this process. Our research has examined a sample of UK-based non-financial firms that traded on the London Stock Exchange between 1998 and 2002.

Our findings suggest that the incidence and independence of nomination committees are affected by the other corporate governance arrangements of the company. Higher degrees of main board independence appear to raise the possibility of establishing a nomination committee and increase the independence of an existing committee. We also demonstrate that increasing share ownership by directors and block holders seems to inspire their direct participation of company's decision making, rather than the establishment of a separate nomination committee. Our work shows important dynamic linkages between various features of the governance arrangements of UK companies. The evidence is consistent with the use of nomination committees to control the influence of large shareholders over the governance of the firm, and further work is warranted to develop this theme.

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### **Notes**

- 1 Data is also available from 1997 to preserve a full five-year window of observations after the construction of lead values of the dependent variables.
- 2 See Gerhart et al (2000) for an accessible link into the literature on survey methods and single rater bias.