

**1° Convegno Annuale
dell'Associazione dei Docenti di Economia dei Mercati e degli Intermediari
Finanziari
(ADEIMF)**

Lecce, 15-16 June 2007

**“The determinants of Outside Director Compensation: an
empirical analysis of UK banks and non-banks”**

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Abstract: *The attention of both policymakers and researchers on corporate governance issues has increased significantly during the last decade. Indeed, it has been proved the important effects that a good corporate governance has for competitiveness of companies and, consequently, for country's economic potential growth. As a result, many countries have introduced Corporate Governance Codes in order to set principles and best practices to stimulate and encourage correct corporate governance framework, especially for listed companies. In this article, we provide an exhaustive review on corporate governance theories and we analyze in depth the UK corporate governance model and codes of best practice. Then, on the basis of the codes' provisions, we examine in particular the board of directors (responsibilities, composition, internal committees), and the independent outsiders' role within the board. After that, combining the human capital and the equity theory, we have developed and tested a model in which the total cash compensation of outside directors in a listed firm is related to: 1) outsider's profile (gender, board position and responsibilities, meeting activity, length of service in the firm and human capital); 2) characteristics of the board of directors (structure, composition and organization); 3) characteristics of firm (industry sector, dimension and earnings). Consistent with our model, the role and responsibility, the meeting activities, length of service and human capital have a significant effect on outsider compensation. We also find that the characteristics of the board, such as size, diversity and CEO compensation level are important. Some inter-industry differences about the remuneration policy are also pointed out in the results.*

JEL Classification: G3; G2 ; J44

Keywords: Corporate Governance, Board of Directors, Outsider Compensation.

May 2007

The authors would like to express their gratitude to: Dr. Yener Althunbas (University of Wales) for his comments; Prof. Paola Schwizer (University of Parma) and Prof. Vittorio Boscia (University of Salento) for their encouragement, constant advice and their detailed comments on the paper.

Another thanks goes out to: Prof. Camilla Mastromarco and Dr. Emanuele Grassi (University of Salento) for comments on certain parts of the paper; Riccardo Mariano (Banca Popolare Pugliese) for his help to providing some balance sheet dataset; Dr. Claudia Castellani (Proudman Oceanographic Laboratory) and Dr. David Marques-Ibanez (European Central Bank) for their friendship. Last but not least, they are very grateful to the SAGA Department (University of Salento) for financing the research.

This paper is the result of a co-operation between the authors. However, Pietro Marchetti has contributed sections 2, 3 and 4 while Valeria Stefanelli has contributed the sections 5, 6, 7, 8.

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1. Introduction

During the past decade, the attention of both policymakers and researchers on corporate governance issues has increased significantly. Indeed, there are important effects that a valid corporate governance has on competitiveness of companies and, consequently, on the country's economic potential growth (OECD, 2005; BIS, 2005; Morck *et al.*, 2005). More recently, this issue has been widely discussed in occasion of the failures of some large corporate structures in United States and Europe (i.e. Enron and Worldcom in USA, Ahold in Netherlands, Parmalat in Italy) (Woo *et al.*, 2000; Maddaloni & Pain, 2004; ECB, 2005). As a result, many countries introduced Corporate Governance Codes to set principles and best practices to stimulate and encourage correct corporate governance framework especially for listed companies.

Research on this topic aim, *inter alia*, to analyse and to model "good" corporate governance mechanisms. Several studies and policies of supranational institutions (i.e. OECD, BIS, ECGI) focus on the composition of the boards. They suggest that it is necessary to increase the number of outside directors on the board and in some specific committees (such as the nomination, audit and remuneration committee) (John & Senbet, 1998; Coles & Hoi, 2003; Linn & Park, 2005). Indeed, outside directors may contribute with their expertise and objectivity in evaluating managers' decisions. However, according to UK Corporate Governance Code, to reduce agency problems outside directors should be adequately incentivated.

While there are many studies that investigate compensation issues of executive directors and CEOs (Coffee, 1991; Core *et al.* 1999; Benito & Conyon, 1999; Cheung & Stouraitis, 2005; Ozan, 2006), there is very little systematic evidence on what determines the compensation of outside directors. Hempel & Fay (1994) report that, for USA corporations, compensation is related principally to board size and meetings, but it is not related to firm performance or CEO compensation. Boyd (1996) reports that firm size, firm profitability, director stockholdings and resource richness are strongly related to outsider compensation. Cordeiro *et al.* (2000) suggest that corporate boards are paying directors on the basis of some reasonable criteria and norms and so they are setting up systematic director pay systems. Linn & Martin (1998), Gerety *et al.* (2001) and Fitch & Shivdasani (2006) investigated security price revaluation surrounding the adoption of equity-based incentive pay plans for outside directors.

Combining the human capital (Mincer, 1974) and the equity theory (Adams, 1963; Miller, 1995), this paper aims to advance literature on these issues by investigating the relationship between the level of the outsider compensation, outsider individual profile (such as experience and popularity) and some characteristics of the board of directors (such as board diversity and CEO compensation). Moreover, as far as the authors know, it is the first time that a paper explains this correlation using the standard human capital earnings function as well as the popularity index (Mueller, 1970).

The sample has been carried out on the English market. There are various reasons for this. Outsiders have an important performing role in Anglo-Saxon governance models (exempt from board of statutory auditors), of the high compliance to the governance standards which enable English companies to define the best practices at an international level (Heidrick & Struggles, 2005) and, therefore, provides the market with high information transparency, quality and reliability. This allows researchers to even collect the qualitative data needed for the development of similar analyses.

The paper is divided into six sections. The first provides an overview of the corporate governance theory. The second section discusses the characteristics of the main corporate governance mechanisms and presents a detailed overview about the UK corporate governance framework. The third section explains the outsider's profile in the UK corporate governance. The fourth section deals with the issue of outside director's compensation and the elements that affect their level. The fifth section describes data and samples, and sets out the methodological framework. The last section summarises the results and their implications.

2. Corporate governance: the state of the art

In the last years corporate governance (CG) issue³ has become more important in all the economic sectors, since most of people believe that sound and efficient CG mechanisms get better corporate performance and competitiveness, and lead more efficiency and transparency of the financial markets (Emmons & Schmid, 1999; Carlin & Mayer, 2003; Claessens, 2003; Holmstrom & Kaplan, 2003; Maddaloni & Pain, 2004; Becht et al., 2005; Morck et al., 2005).

Since Berle & Means original work (1932) on the separation between ownership and control, and the power's loss of shareholders⁴, many theories on CG were developed with a specific role of the board of directors in each one. After Coase studies (1937), the US economic doctrine elaborated a *contractual theory of the firm*⁵, according to which firm is a *nexus of contracting relationships*. In this sense, there is also the *agency theory*, which examines differences of interests between principal (shareholders) and agent (management), and considers information asymmetry in their relationship (Jensen & Meckling, 1976; Fama, 1980; Fama & Jensen, 1983a e 1983b)⁶.

According to Jensen & Meckling (1976), there is an agency relationship when “*one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent*”. Agency problems are closely connected with ownership's issue: in fact, shareholders' capability to monitor managers depends on the ownership's structure. When the separation between ownership and control increases also agency costs increase, and they cannot eliminate but only mitigate (Zattoni, 2006), and that involves shareholders who are owner of the *residual claims* (Fama & Jensen, 1983a).

A lot of empirical studies on agency problems (Shleifer & Vishny, 1986 e 1997; Li, 1994; Bathala & Rao, 1995; Denis & Sarin, 1999; La Porta et al., 2000; Gillan & Starcks, 2003; Hermalin & Weisbach, 1991 e 2003; Becht et al., 2005; Lasfer, 2006) demonstrate that independent outsider directors in the board, internal committees with majority independent, responsibilities' division between Chairman and CEO, incentive systems for managers, are all effective CG mechanisms that reduce agency costs⁷. In the large listed companies a further effective mechanism to remove an inefficient management is the *market for corporate control*, as Manne (1965) said, in the form of *hostile takeovers* which give small shareholders both power and protection commensurate with their interest in corporate affairs⁸. According to agency theory both inside and outside control systems, board and market respectively, one *ex ante* the other *ex post*, oversee managers' opportunistic behaviours effectively⁹.

³ As Becht et al. (2005) observed, “*the term CG derives from an analogy between the government of cities, nations or states and the governance of corporation*”, and it seems to have been used first by Eells (1960), to denote “*the structure and functioning of the corporate polity*”. There are many definitions of CG, out of all these the Cadbury Committee's definition (1992): “*CG is the system by which companies are directed and controlled*”, and Shleifer & Vishny (1997) one: “*CG deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment*”, then integrated by Claessens (2003) “*...with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders*”; Zingales (1997) defined CG “*as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by a firm*”, and La Porta et al. (2000) as “*a set of self-enforceable rules (formal or informal) that regulates the contingent action choices of the stakeholders (investors, workers, and managers) in the corporate organisation domain*”. So, OECD (2004) defined CG as “*a set of relationships between a company's management, its board, its shareholders, and other stakeholders. CG also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good CG should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective CG system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy*”.

⁴ Berle & Means (1932) found that importance of a shareholder's vote reduces itself when the number of shareholders increases, until it becomes unimportant in very large companies.

⁵ See Easterbrook & Fischel (1991).

⁶ A survey on agency theory and theoretical and empirical researches is in Eisenhardt (1989).

⁷ According to the agency theory irreparable differences between owners and managers, and managers' tendency to adopt opportunistic behaviours have to be managed with the board of directors and incentive systems. See Hung (1998).

⁸ Outside control mechanism of market was empirically emphasized by Shleifer & Vishny (1997) and Holmstrom & Kaplan (2003). On the contrary, as Parbonetti (2006) observes, classical managerialism's theorists (Baumol, Marris, Gordon) thought both market and board were ineffective mechanisms of management control, because “*managers self-legitimize their power because of specific competences they have*”.

⁹ A review on agency problems between managers and shareholders and empirical researches on mitigation mechanisms is in Shleifer & Vishny (1997) and Denis (2001). Moreover, in their study Rediker & Seth (1995) found a substitution effect in the

On the contrary, stewardship theorists maintain that a CG model based on agency theory stimulate opportunistic behaviours, not reduce them, because management's motivation is linked to outside incentive schemes, such as stock options (Donaldson & Davis, 1991; Davis et al., 1997; Muth & Donaldson, 1998). According to the *stewardship theory* management's motivations are internal, for example the wish of self-realization. Thus, management behaves not as an *agent* but as a *steward*, and co-operates with shareholders to satisfy firm's interests. Even in this case opportunistic behaviours are possible to verify, but they can be controlled by a self-valuation of the managers. Consequently, the board of directors has a strategic role and doesn't control managers any more, it could be constituted by executives prevalently, and the role's separation of Chairman and CEO isn't necessary¹⁰. There is some adverse criticism of this theory, especially on account of its hypothesis that managers' behaviour is aligned with shareholders' interests (Tricker, 1994; Parbonetti, 2006).

Another theory of Pfeffer & Salancik (1978) examines the interdependence between a firm and its environment. According to the *resource dependence theory*, firm is an open system and its survival depends on the capability to take and keep the resources it needs, considering the environmental uncertainty and variability. In this sense, the board doesn't protect firm's interests, but it faces up to the environmental uncertainty and evolution: therefore the board of directors is a link between firm and external environment¹¹. Consistent with the *resource-view*, by its heterogeneity of skills, knowledge and experience, the board (especially its non-executive directors) influences firm's performance because it provides external resources (Mace, 1971; Conner & Prahalad, 1996). So on the basis of the resources directors put at firm's disposal, we can distinguish them in: *insider* (executive), *business expert* (non-executive expert in the guidance of firm), *support specialist* (non-executive with specific skills) and *community influential* (able to set connections with social environment)¹². But in this theory it isn't clear what is board's composition more effective: for example, the presence of female directors, independent outside directors, diversity of background and nationality, are all important within the board¹³.

In these different theories there are many contradictions that support the conception of firm not as a nexus of contracts but as a network of relationships, or rather "*a network of specific investments that cannot be replicated by the market*" (Rajan & Zingales, 1995). And so, apart from mechanisms to regulate a *principal-agent* relationship in agency theory, the concept of CG involves also a *firm-stakeholder* relationship¹⁴. Consequently, German and Japan *stakeholder model* of CG, based on a compromise of different interests, opposes the traditional US and UK *shareholder model*, based on agency costs and incentive mechanisms to reduce them.

According to the *stakeholder theory*¹⁵, developed by Freeman (1984), given the "social responsibility" of firm towards all the stakeholders, just the *co-operative and fiduciary relationships* with different stakeholders allow firm to get competitive advantages¹⁶. In this sense, board becomes a fundamental

management control of outside directors, large shareholders, inside executives themselves and incentive mechanisms, so firms can choose their effective combination of mechanisms, both outside and inside, to lead an alignment of interests between management and shareholders. Also Weisbach (1988) found a substitution effect between outside directors and market's takeovers; similarly Weir et al. (2003), but they found that market's mechanism was more effective than inside mechanism. On the contrary Agrawal & Knoeber (1996) found an interdependence of all the governance mechanisms except for outside directors.

¹⁰ See Donaldson & Davis (1991), Brickley et al. (1997), Davis et al. (1997), Muth & Donaldson (1998), Dedman & Lin (2002), McKnight et al. (2005), who find that duality of roles gets better firm's performance and shareholders' gains.

¹¹ As Pfeffer & Salancik (1978) said: "*the board is primarily of use to provide linkage to the environment*". See also Mace (1971) and Conner & Prahalad (1996).

¹² See Parbonetti (2006). The above-mentioned classification of directors is drawn by Hillman et al. (2000).

¹³ Among criticism of resource-based theory, see Foss (1996). See also Ruigrok et al. (2006).

¹⁴ In particular, Claessens (2003) said: "*CG would include the relationship between shareholders, creditors, and corporations; between financial markets, institutions, and corporations; and between employees and corporations. CG would also encompass the issue of corporate social responsibility, including such aspects as the dealings of the firm with respect to culture and the environment*".

¹⁵ Stakeholders approach was formulated first by Freeman (1984), then a more complete theory was expressed by Evan & Freeman (1988). See also Donaldson & Preston (1995).

¹⁶ According to this theory, the network of favourable relationships between firm and stakeholders is one of the elements of organization wealth, one of the *intangible assets* of firm. So the adoption of stakeholder view of firm involves also important ethical and legal implications for managers, who have the responsibility to maintain and increase organization wealth on the basis of all the stakeholders interests. In this sense D'Orazio (2004) talks "ethical leadership" in the management of stakeholders.

“structural mechanism” able to integrate different interests in the decisional process (Evan & Freeman, 1988).

Besides, to reduce agency problems it's useful to concentrate ownership in the hands of a few large shareholders (*blockholders*), as Stiglitz (1985) said. Large shareholders (typically institutional investors), with their voting power, can monitor better management behaviour and firm's performance, and protect also the interests of small shareholders (Faccio & Lasfer, 1999; Leech, 2001; Claessens et al., 2000 e 2002; Claessens & Fan, 2002; Crespi-Cladera & Renneboog, 2003; Gillan & Starks, 2003; Becht et al., 2005; Altunbas et al., 2007). But blockholders involve also some disadvantages, because large shareholders could assign further benefits, so called *private benefits of control*, to the detriment of small shareholders which can be deprived of some of their rights¹⁷. Since a liquid stock market reduces the costs with an optimal diversification of risks (Maug, 1998), it seems to be a “trade-off between liquidity and control” because institutional investors that want liquidity of their investments often may hesitate to accept control of the firms whose shares they possess (Coffee, 1991; Bolton & Von Thadden, 1998; Becht & Röell, 1999).

We consider two other CG theories in short, even if there are few empirical studies of these. According to the *institutional theory* (Selznick, 1957), institutionalization promotes organizational stability over time and so board of directors has only to maintain the relationship between firm and environment: on one hand the board is a technical instrument to define aims, on the other hand it is an adaptive vehicle shaped in reaction to the influences from the external environment (Meyer & Rowan, 1977; Scott & Meyer, 1983; Ingram & Simons, 1995). Some scholars criticize this theory for the lack of explicit attention to strategic behaviour that organizations employ in direct response to the institutional processes that affect them. Finally, consistent with the *managerial hegemony theory* (Mace, 1971) top and senior managers define governance structure with the ultimate aim to reduce transaction costs and so boards are a managerial tool to support managers decisions (Whisler, 1984).

The six theories we briefly analyzed, as Zahra & Pearce (1989) and Johnson et al. (1996) said, assign a different role, even set against, to the board of directors, while board should carry out more roles at the same time¹⁸. In particular, agency theory assigns a control role of management, resource-view a linking role with external environment, stewardship theory a strategic role, stakeholder theory a coordinating role of interests, institutional theory a maintenance role and managerial hegemony theory a support role to the management decisions (Table I)

¹⁷ Morck et al. (2005) talk about *entrenchment* of management and *disalignment* of the large and small shareholders interests. Many empirical studies, for instance Grossman & Hart (1988) and Bebchuk (1999), dealt with the issue of private benefits of control by two different methodologies (measurement of the value of blockholders votes or individual vote), to evaluate if blockholders votes are worth more than small shareholders ones. Other scholars, as Hermalin & Weisbach (2003), found the board of directors as an effective mechanism to minimize private benefits of managers. A review is in Dyck & Zingales (2004). See also Coffee (1991); Hart (1995); Shleifer & Vishny (1997); Bolton & Von Thadden (1998); Holderness & Sheehan (1998); Maug (1998); La Porta et al. (1999); Claessens et al. (2000 & 2002); Börsch-Supan & Köke (2002); Claessens & Fan (2002); Carlin & Mayer (2003); Dyck & Zingales (2004).

¹⁸ Further details on different theories in Hung (1998); Parbonetti (2006); Zattoni (2006). A review on the board's role in Carretta et al. (2005).

Table I – A survey of the CG theories, empirical studies and board's roles.

Theory	Empirical studies	Board of directors
<i>Agency</i> (Jensen & Meckling, 1976; Fama, 1980; Fama & Jensen, 1983a e 1983b).	Shleifer & Vishny (1986), Weisbach (1988), Hermalin & Weisbach (1991), Li (1994), Bathala & Rao (1995), Rediker & Seth (1995), Agrawal & Knoeber (1996), Shleifer & Vishny (1997), Denis & Sarin (1999), La Porta et al. (2000), Gillan & Starcks (2003), Hermalin & Weisbach (2003), Holmstrom & Kaplan (2003), Weir et al. (2003), Becht et al. (2005), Lasfer (2006), Ruigrok et al. (2006).	<i>Control</i> role.
<i>Stewardship</i> (Donaldson & Davis, 1991).	Tricker (1994), Brickley et al. (1997), Davis et al. (1997), Muth & Donaldson (1998), Dedman & Lin (2002), McKnight et al. (2005).	<i>Strategic</i> role.
<i>Resource dependence</i> (Pfeffer & Salancik, 1978; Conner & Prahalad, 1996).	Foss (1996), Hillman et al. (2000), Ruigrok et al. (2006).	<i>Linking</i> role.
<i>Stakeholder</i> (Freeman, 1984; Evan & Freeman, 1988).	Grossman & Hart (1988), Coffee (1991), Hart (1995), Shleifer & Vishny (1997), Bolton & Von Thadden (1998), Holderness & Sheehan (1998), Maug (1998), Bebchuk (1999), Becht & Röell (1999), Faccio & Lasfer (1999), La Porta et al. (1999), Claessens et al. (2000), Leech (2001), Börsch-Supan & Köke (2002), Claessens et al. (2002), Claessens & Fan (2002), Carlin & Mayer (2003), Crespi-Cladera & Renneboog (2003), Gillan & Starks (2003), Hermalin & Weisbach (2003), Dyck & Zingales (2004), Becht et al. (2005), Morck et al. (2005), Altunbas et al. (2007).	<i>Coordinating</i> role.
<i>Institutional</i> (Selznick, 1957).	Meyer & Rowan (1977), Scott & Meyer (1983), Ingram & Simons (1995).	<i>Maintenance</i> role.
<i>Managerial hegemony</i> (Mace, 1971).	Whisler (1984).	<i>Support</i> role.

Source: Authors' elaboration.

Numerous studies dealt with the connection between a well-defined law and legal framework, CG rules included, and the economic growth and well-being for a country (Hart, 1995; Deakin & Hughes, 1997; La Porta et al., 1997, 1998 & 2000; Levine, 1999 & 2005; Claessens, 2003; Becht et al., 2005; Beiner et al., 2006; Laeven & Levin, 2006; Yermack, 2006). In particular, Claessens (2003) focused on the importance and impact of CG rules for the functioning and development of market economies: a sound and effective CG allows firms to increase access to external financing, to cut cost of capital and raise firm valuation consequently, to have better operational performance through better allocation of resources and better management, to reduce risk of financial crises, to have better relationships with all stakeholders.

Also institutional regulators recognized the importance of CG for firms conduct and performance, especially for large companies, proved by theories and studies above-mentioned. At the beginning of 1990s, a lot of documents dealt with CG (recommendations, reports, codes, guidance, principles) appeared all around the world¹⁹, issued by supervision institutions, public authorities, international

¹⁹ The first code of good governance published in the USA by the Business Roundtable in 1978 (*The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*), and since the late 1970s other codes issued by the Securities Exchange Commission (SEC), the New York Stock Exchange (NYSE) and the Business Roundtable itself. However, only after a decade later another country created a code of good governance: in 1989 the Hong Kong Stock Exchange and in 1991 the Irish Association of Investment Managers published their codes of best practice for listed companies. Nevertheless, the development of codes grew rapidly in the early 1990s, following the Cadbury Report (1992) in the UK: the Viénot Report in France (1995, revised in 1999), the Peters Report in the Netherlands (1997), in 1999 the Cardon Report in Belgium, the Olivencia Report in Spain and the Preda Code in Italy (revised in 2006), the Cromme Report (2002) in Germany. The worldwide diffusion of codes of good governance was studied by Aguilera & Cuervo-Cazurra (2004), who found that the two main diffusion explanations are efficiency needs (in terms of the characteristics of shareholders protection) and legitimating pressures (in terms of government liberalization), both complementary, while in the previous literature these dual forces, one endogenous and the other exogenous, were considered incompatible. See also Enriques & Volpin (2007), who compared CG reforms in France, Germany and Italy with US ones. Besides, Lannoo (1999) studied a European perspective on CG, while Holmstrom & Kaplan (2003) the US one. See also OECD (2003) and De Andres et al. (2005).

organizations, class associations and so on, and those documents were often of a non-mandatory nature but “voluntary” or “self-regulatory” one (*moral suasion*). In fact, self-regulation was fundamental to diffuse CG issues, because even though the adoption of CG models shown in those documents was quite voluntary many firms spontaneously implemented, also for market pressures or the fear of reputational damage. Yet in some countries implementation of CG codes became a mandatory requirement to list companies on the stock exchange markets, in other countries CG provisions were included into the national statutory law, as the rigidity of US regulation. One of the essential differences between hard and soft rules is in the famous “comply or explain” principle of soft rules: even if the code is binding as a requirement, it’s not binding as to substance. In practice, firms subject to the code, usually listed companies, are invited to adhere to the code (*comply*), but if they decide to not follow its provisions they have to state their reasons (*explain*)²⁰.

After the “OECD Principles of Corporate Governance” (1999, revised in 2004)²¹, the CG codes diffused worldwide, especially in Europe. The non-mandatory OECD Principles constitute one of the twelve key standards of the *Financial Stability Forum* for sound financial systems, and the national CG codes often base on the OECD Principles²².

On 15 February 2005, the European Commission (EC) adopted a recommendation about the role of non-executive and independent directors in listed companies, to increase their presence and role within boards in order to protect all the stakeholders and reduce potential conflicts of interest²³. And on 14 December 2004, the EC adopted another recommendation about the directors compensation in listed companies, because EC thought that accurate information disclosure about remuneration policy meant lack of a conflict of interest²⁴. These two EC recommendations include CG principles and rules that, even if not bound, are actually rigorous and detailed, and this is in contrast with the EC admission of inappropriateness of the “CG European code”²⁵.

Also in banking system CG issues are relevant²⁶ and we can distinguish two alternative currents in literature. Some authors highlight specificity of banks (Adams & Mehran, 2003; Flannery et al., 2004; Masera, 2006), and so they legitimize government policies on the governance of banks; despite special peculiarities of banks²⁷, other scholars (La Porta et al., 2000 & 2002; Levine, 2004) believe it doesn’t

²⁰ This principle is expressly mentioned in the Belgium, Germany, Hungarian, Italy, Netherlands, Polish and UK codes. But “comply or explain” principle has one obvious drawback, as Wymeersch (2006) found: “if companies are free to set aside provisions of the code, provided they publish some sort of explanation, will this explanation be true and reliable?”. Some jurisdictions, especially the Netherlands, believe the securities supervisor should only be involved in checking that the CG statement conforms with the code, and not be involved in checking the content which should be entirely left to the board of directors. Instead in other countries, as Spain, the securities commission is also mandated to check compliance with the code.

²¹ Apart from participate in the revision process of OECD Principles, the ICGN (*International Corporate Governance Network*) issued principles, revised in July 2005, that partly reflect OECD principles and partly are additional ones. See ICGN (2005).

²² In the USA, as an attempt to standardize the company law, in 1984 the American Bar Association issued the Model Business Corporation Act (MBCA), adopted by only few Countries; moreover, since 2002 the Sarbanes-Oxley Act (SOA) is in force for listed companies, with rigid organization and governance rules, and the NYSE and NASDAQ recommendations. In Europe, as indicated, the UK first issued the Cadbury Report in 1992 and than other codes of best practice, until the Revised Combined Code in June 2006.

²³ Among the principles of EC Recommendation (2005): a balance of executive and non-executive directors and a sufficient number of independent directors, especially within audit, remuneration and nomination committees; director independency as a lack of any relationships (professional, familiar or other) which could influence his decisional autonomy; all members of the supervisory board provided with professionalism, authoritativeness and experience.

²⁴ Among the principles of EC Recommendation (2004): a complete information disclosure about remuneration policy and individual compensation of directors, showing all the components, fixed and variable, and remuneration policy approved by shareholders’ meeting.

²⁵ In fact, during consultations, in 2004 the EBF (European Banking Federation) had doubts about these recommendations and believed they affected issues, overlapping or contrasting, regulated by different national laws and codes of best practice in the countries. On the contrary, Lannoo (1999) wished some harmonization to standards for CG in the EU.

²⁶ The debate on CG of banks arises from Fama’s work (1985). A recent review on the state of the art is in Polo (2007).

²⁷ Levine (2004) found two related characteristics of banks that make them special compared with non-financial firms: their greater opaqueness (information asymmetry, that is difficulty of investors to have information about bank behaviour and monitor ongoing bank activities) and, consequently, their greater government regulation (at the extreme, State-owned banks). He also reviewed literature about implications of these special features for banks governance and concluded that public policy should seek to enhance private monitoring of banks, and governments can improve the development and enforcement of accounting and auditing standards, and punish violators. Moreover, “the traditional CG mechanisms rely on well-functioning legal and bankruptcy systems that effectively support the rights of shareholders and creditors. But, these

motivate a separate analysis of the governance of banks from others firms. According to the Basel Committee on Banking Supervision (2006), “*given the important financial intermediation role of banks in an economy, their high degree of sensitivity to potential difficulties arising from ineffective CG and the need to safeguard depositors’ funds, CG for banking organisations is of great importance to the international financial system and merits targeted supervisory guidance*”²⁸ to promote the adoption and implementation of sound CG practices by banking organisations in different countries, which principles should be proportionate to the size, complexity, structure, economic significance and risk profile of each bank. A sound CG is an essential element in the safe and sound functioning of a bank and may affect the bank’s risk profile if not implemented effectively²⁹. As Levine (2004) said, “*if bank managers face sound governance mechanisms, they will be more likely to allocate capital efficiently and exert effective CG over the firms they found*”³⁰. “*From a banking industry perspective, corporate governance involves the manner in which the business and affairs of banks are governed by their boards of directors and senior management*”³¹, which affects how they:

- *Set corporate objectives;*
- *Operate the bank’s business on a day-to-day basis;*
- *Meet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders;*
- *Align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations;*
- *Protect the interests of depositors”* (BIS, 2006).

Among the sound CG principles of Basel Committee for an effective governance of banks, we highlight: “*Banks should have an adequate number and appropriate composition of directors who are capable of exercising judgment independent of the views of management, political interests or inappropriate outside interests. (...) Independence and objectivity can be enhanced by including qualified non-executive directors on the board or by having a supervisory board or board of auditors separate from a management board*”³² (BIS, 2006).

Moreover, especially in one-tier systems, bank boards have found it beneficial to establish certain specialised and qualified committees to advise the board, whose independence is assured by a majority of non-executive directors at least³³. Among these specialised committees, are important: the audit committee for internal control, especially for large and internationally active banks; the risk management committee, for oversight of senior management’s activities; the compensation committee, for remuneration of senior management and other executives; and the nominations/CG/human resources committee.

Another fundamental principle of sound CG concerns, for board or its independent committee, the adoption of remuneration policies and practices which are “*consistent with the bank’s corporate*

institutions do not operate well in most countries. Thus, it is not too soon to begin the long-process of building sound legal and bankruptcy systems”.

²⁸ See BIS (2006).

²⁹ In their recent work, Laeven & Levine (2006) found that bank risk taking depends also on ownership structure and CG model adopted, apart from investor protection laws and bank regulations.

³⁰ In particular, Levine (2004) said: “*Given the importance of banks, the governance of banks themselves assumes a central role. If bank managers face sound governance mechanisms, they will be more likely to allocate capital efficiently and exert effective CG over the firms they fund. In contrast, if banks managers enjoy enormous discretion to act in their own interests rather than in the interests of shareholders and debt holders, then banks will be correspondingly less likely to allocate society’s savings efficiently and exert sound governance over firms*”.

³¹ As Basel Committee (2006) recognized, “*there are significant differences in the legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management*” (for example, the UK one-tier structure vs. German two-tier structure). So the notions of board of directors and senior management are used in this work to identify the management and oversight functions within a bank.

³² As Carretta et al. (2005) observed, given the greater complexity of their activities, much more members and independent directors constitute boards of financial intermediaries compared with non-financial firms, and there are also more executive and audit committees.

³³ Ruigrok et al. (2006) studied the determinants and effects of board nomination committees on the Swiss public companies, and they demonstrated the importance of nomination committees within boards. Previously, Jensen & Murphy (1990) found the existence of a relationship between firms performance and executives appointment and turnover; however, boards with nomination committees made more effective the appointment and turnover process.

culture, long-term objectives and strategy, and control environment” (BIS, 2006), in order to mitigate potential conflicts of interest and provide assurance to shareholders and other stakeholders.

Finally, in particular for listed banks, “*transparency is essential for sound and effective CG*” (BIS, 2006) and among information related more specifically to the governance of the bank we underline:

- “*Board structure (e.g. by-laws, size, membership, selection process, qualifications, other directorships, criteria for independence, material interests in transactions or matters affecting the bank, and committee membership, charters and responsibilities) and senior management structure (e.g. responsibilities, reporting lines, qualifications and experience);*”
- *Basic ownership structure (e.g. major share ownership and voting rights, beneficial owners, major shareholder participation on the board or in senior management positions, shareholder meetings);*
- *Organisational structure (e.g. general organisational chart, business lines, subsidiaries and affiliates, management committees);*
- *Information about the incentive structure of the bank (e.g. remuneration policies, director and executive compensation, bonuses, stock options)”* (BIS, 2006)³⁴.

3. Characteristics of the UK corporate governance model

The development of CG issues in the UK has its roots in a series of corporate failures and financial scandals in the late 1980s and early 1990s, including the collapse of the BCCI bank and the Maxwell Communications pension funds scandal, both in 1991. These crises reduced investors trust and confidence, and made intervention on CG systems necessary. For these reasons, a “Committee on the Financial Aspects of CG”, chaired by Sir Cadbury, was set up in May 1991, and the Committee published a series of recommendations (known as the *Cadbury Report*) in 1992. The Cadbury Report addressed issues such as the board composition (at least one-third of its members should be non-executive directors, a majority of whom independent), the separation between the roles of Chairman and CEO, the service contracts not over three years, the appointment and remuneration of executive directors (set by specific committees, made up mainly of non-executives), and company’s financial reporting and controls (setting an audit committee, including at least three non-executives). Also, the Cadbury Report promoted a greater involvement of shareholders (especially institutional ones), by their voting power, in company’s business. Beginning from 30 June 1993, the London Stock Exchange introduced a requirement into the *Listing Rules* requesting all companies to include a statement of compliance, or non-compliance, with the Cadbury provisions (*comply or explain*). Owing to increasing levels of directors remuneration to the detriment of firms performance, in 1995 the Greenbury Committee was established and set out a “Code of Best Practice on Director’s Remuneration” dealt with the role of a remuneration committee (comprising entirely of non-executives) in setting the remuneration packages for the CEO and other executives, the required level of disclosure and whether shareholders approval needed, specific guidelines for determining a remuneration policy for executives, the service contracts not over 12 months, and provisions binding firms to pay compensation to a director, particularly in the event of dismissal for unsatisfactory performance. The Hampel Committee was established in November 1995 to revise the earlier recommendations of the Cadbury and Greenbury Committees. The *Hampel Report*, published in 1998, advanced in the area of accountability and audit: the board was identified as having responsibility to maintain a sound system of internal control and all aspects of risk management, as opposed to just the financial controls as recommended by the Cadbury Report³⁵.

The *Combined Code* (1998) consolidated the principles and recommendations of the Cadbury, Greenbury and Hampel Reports, and it was divided into two sections. The first outlined principles of best practice and their supporting provisions for *companies*, such as the composition and operations of boards, executives remuneration, relationship with shareholders, the supply of information, and

³⁴ About effectiveness of a voluntary disclosure to reduce information asymmetry and its link with CG, see Core (2001). About the convergence of Anglo-Saxon and non-Anglo-Saxon systems of disclosure and governance practices, see Markarian et al. (2007).

³⁵ The Hampel Report emphasized “principles” of good CG (and this emphasis on principles would survive into the Combined Code) rather than explicit rules, in order to reduce the regulatory burden on companies and make applicable authoritative but flexible rules to all companies.

accountability and audit. The second section did the same for *institutional shareholders*, covering shareholders voting, dialogue with companies, and the evaluation of governance disclosure.

In 1999 (further revised in 2005) the *Turnbull Guidance* was issued to provide directors with guidance on how to develop a sound system of internal control (operational, financial and compliance) and risk management, emphasising the importance of the annual disclosure and regular and systematic assessment of the effectiveness of internal control systems.

In January 2003 two reports were published: the *Higgs Report*, on the role, independence and recruitment of non-executive directors³⁶, and the *Smith Report* on the role of audit committees³⁷. The *Revised Combined Code*, issued in July 2003, was a direct result of the Higgs and Smith recommendations and it was effective for companies after 1 November 2003. The new Code produced a significant revision of the 1998 Code, in particular the new Code emphasized: a clear division of the Chairman and CEO roles (in addition, the Chairman should satisfy the criteria for independence on appointment, but these criteria were different from independent directors ones); a board of at least half independent non-executives (and the definition of independence was drawn by the Higgs Report); candidates for board selection to be drawn from a wider pool; the board, its committees and directors to be subject to an annual performance assessment³⁸; at least one member of the audit committee to have recent and relevant financial experience; and, in contrast to the Higgs Report, the possibility for the Chairman to chair the nomination committee, except where the committee is considering the appointment of the Chairman's successor.

Following a review by the Financial Reporting Council (FRC) of the implementation of the Code in 2005 and subsequent consultation on possible amendments to the Code, in June 2006 a new *Revised Combined Code* was published and it was effective for companies after 1 November 2006³⁹.

As above we highlighted, the key aspects of CG in the UK can be outline in this way:

- One-tier system: a single board collectively responsible for the success of the company;
- Checks and balances: a clear division of responsibilities with a separate CEO and Chairman, a balance of executive and independent non-executive directors (in particular, for larger companies at least half of the board members should be independent non-executives), independent audit and remuneration committees, annual evaluation by the board of its performance;
- Emphasis on objectivity of directors in the interests of the company;
- Transparency on appointment and remuneration procedures;
- Effective rights for shareholders;
- “Comply or explain” principle for the implementation of the code.

³⁶ In particular, Higgs (2003) viewed the non-executive directors role as: making contributions to corporate strategy, monitoring the performance of executives, satisfying themselves regarding the effectiveness of internal control, setting the executives remuneration, and involvement in the nomination, removal and succession planning of senior management. The 1998 Code recommended that boards should include at least one-third of non-executive directors, a majority of whom should be independent, without detailing how to assess “independence” and how to appoint independent directors. Therefore Higgs filled this gap and clarified that directors in a conflict of interests or cross-directorships compromised independence. Furthermore, Higgs recommended all listed companies to establish a nomination committee, chaired by an independent non-executive director (not the Chairman) and comprising a majority of independent non-executive directors. Other important recommendations of the Higgs Report included a periodic (at least annual) performance’s review of the board, its committees and directors, and information disclosure on the executives remuneration policies.

³⁷ Art. 3 of the Smith Report, about composition of the audit committee, recommended that the audit committee included at least three members, all of them independent non-executives, and at least one of them should have recent and relevant financial experience. These two Reports, Higgs and Smith, often referred to one another: Higgs didn’t deal the audit committee and referred to Smith recommendations; Smith, in his turn, mentioned independent directors but referred to Higgs Report for a definition of them. This fact proves two working groups were in contact with them and both aimed a co-ordinated revision of the Combined Code.

³⁸ Assessment of the board performance (on the whole or its committees and members) is very important in order to improve the quality of CG, but it’s a complex process which has to consider the board’s different profiles of quality and quantity (structural, organizational and competence). Also, evaluation could be alternatively entrusted to the Chairman, directors (auto-evaluation of the board or reciprocal *peer evaluation*) or an external independent “valuator” (for instance, Deloitte and Spencer Stuart). See Carretta et al. (2005), when authors proposed an operative model to evaluate performance of the board and its members, with particular reference to the financial intermediaries specificities.

³⁹ In the 2006 *Revised Combined Code* there aren’t essential news, except the addition of the Listing Rules (*paragraph 9.8.6*) into the annual disclosure (*Schedule C: Disclosure of corporate governance arrangements*).

Following the Cadbury Report (1992), several scholars analyzed the changes in the UK CG and the real compliance to the Code provisions by the UK listed companies⁴⁰. In particular, between the pre- and post-Cadbury periods they found an increase in the separation of the CEO e Chairman roles (Conyon, 1994; Dedman, 2002; Lasfer, 2006; Weir et al., 2003)⁴¹, and the proportion of non-executive directors on the board (Cosh & Hughes, 1997; Young, 2000; Peasnell et al., 2000 & 2003; Dahya et al., 2002)⁴², and almost all the boards with an audit committee made up of independent non-executive directors for about three quarters (Vafeas & Theodorou, 1998; Weir et al., 2003).

Though one-tier system too, the US CG model is different from the UK one. First, in the US governance system a duality of CEO and Chairman roles is more evident and all the companies are obliged to adopt the SOA (2002) rules, because there isn't "comply or explain" principle. So listed companies have to include a majority of non-executive and independent directors on their board, and establish at least three advisory committees (audit, remuneration, nomination/CG), made up by only independent directors, and boards are responsible for the CEO *hiring & firing*. In addition, the NYSE and NASDAQ recommendations (2003) require that listed companies boards include a majority of independent directors.

Some empirical studies about a comparison in the US and UK systems found: in the UK firms the average number of board members was 8 (Dedman, 2002), whereas in the US ones was 12 (Yermack, 1996); in the UK boards the proportion of executives was higher (Cosh & Hughes, 1997; Peasnell et al., 2000 & 2003; Weir et al., 2003) than the US boards (Bhagat & Black, 1998), and there was a clear separation of Chairman (non-executive) and CEO (executive); besides, in the UK listed companies institutional investors, with a more concentrated ownership, were more influent; finally, in the UK executives turnover for dismissal was lower than in the US and both the sensitivity of CEO compensation to firm's performance and the average of shares owned by CEO were lower in the UK than in the US (Conyon & Murphy, 2000).

After changes in company laws (D. Lgs. 6/2003), now the Italian public companies could choose among three alternative CG models⁴³. In the traditional model, a sole director or a board of directors administrate and a "collegio sindacale" controls (similarly to an audit committee, but the former acts *ex ante* and the latter *ex post*), both appointed by shareholders' meeting. In the one-tier model (based on the Anglo-Saxon one), a board of directors (made up by at least one-third of independent directors)

⁴⁰ Instead, O'Sullivan (2000) analyzed the impact of board composition and ownership on audit quality in the UK before the adoption of the Cadbury Report.

⁴¹ As Dedman (2002) observed, several companies had a duality of roles again and didn't respect the requirement of at least three non-executives into their board. According to Lasfer (2006) and Hillier & McColgan (2006) that was due to a strong negative relationship between the level of managerial ownership and the board's structure: the more managerial ownership was high, the more managers created a board that was unlikely to monitor (more executives into the board, duality CEO/Chairman, not compliance with the Cadbury recommendations). But some empirical evidences found duality of roles wasn't always harmful to firms performance. On the contrary, Donaldson & Davis (1991) and Brickley et al. (1997) observed better performance in the US companies that combining the two roles, as Dedman & Lin (2002) and McKnight et al. (2005) found in the UK companies. Instead, Dalton et al.(1998) and Vafeas & Theodorou (1998) found separation of roles didn't influence financial performance of companies.

⁴² On the contrary, Lasfer (2006) found a steady proportion of non-executive directors on the board, from 42,7% in 1990 to 43,13% in 1996. Moreover, Udueni (1999) and Peasnell et al. (2003) found only a few of non-executives were really independent. Following a study of Protiviti (2005), an independent risk consulting company, on the profile of Italian independent directors, Santella et al. (2006) investigated about this topic with reference to the Italian case and found Italian listed companies didn't really apply the independence standards (required by the Preda Code, 2002, and the EC Recommendation, 2005) they declared they followed. In particular, they studied the 40 Italian Blue Chips in 2003 and found compliance with the Preda Code standards for only 5 out of the 284 directors formally identified as independent by their companies, and for only 4 directors with respect to the EC standards. These results suggest that in almost all cases company disclosure either contradicts alleged director independence or doesn't allow to verify it. Then, the same authors (see Santella et al., 2007) expanded their previous analysis and found a general low level of compliance with independence requirements for both financial and non-financial companies. In particular, they found that "*financial companies show a lower level of compliance than non-financial ones, and are connected with each other and with a few non-financial companies through networks of cross-directorships: two directors (one independent and one executive) who also sit at the same time on another company board*". In addition, they found those non-financial companies with a relatively fragmented shareholder structure tended to be characterized by higher levels of compliance and disclosure than tightly-controlled non-financial ones. On the contrary, financial companies with fragmented shareholder structure tended to be characterized by low disclosure levels, although such companies were also subject to strong financial supervision.

⁴³ For "control" we exclusively intend the management control, while for the Italian listed companies the accounting control isn't internal, but assigned to an external audit, appointed by shareholders' meeting.

administrates and a “comitato per il controllo sulla gestione” (appointed by board and made up entirely by non-executives, with the same roles of collegio sindacale) controls; finally, in the two-tier model (inspired by German and French systems), a “consiglio di gestione” (appointed by supervisory board) administrates and a “consiglio di sorveglianza” (appointed by shareholders’ meeting, with other roles apart from the collegio sindacale ones) controls.

In addition, the new Italian Code of self-regulation (2006) for listed companies recommended them to establish audit committees (made up by non-executives, a majority of whom independent), remuneration and nomination committees (both made up by a majority of non-executives), and (if CEO=Chairman) a nomination of a *lead independent director*. Finally, the number of Italian independent directors is lower than Anglo-Saxon average, because they have to be only in a “adequate number” on the board⁴⁴. In May 2007, the Consob (an Italian supervision authority for listed companies) introduced the Attachment 5-bis on the calculation of cross-directorship limits ex art. 148-bis, par. 1, D. Lgs. 58/1998⁴⁵.

In Table II we compare the UK, US and Italy essential rules of CG.

Table II – The UK, US and Italy CG rules: a comparison.

UK (one-tier system)	US (one-tier system)	ITALY (3 alternative models)
Combined Code (1998) and Revised Code (2003 and 2006); Turnbull (1999 and 2005) and Smith Guidance (2003); Higgs Good Practice (2003).	SOA (2002); NYSE and NASDAQ Recommendations (2003).	D. Lgs. 58/1998 and 6/2003; Preda Code (1999) and Revised Code (2002 and 2006); CONSOB Guidance (2007).
<ul style="list-style-type: none"> ▪ <i>Board composition:</i> a balance of non-executive and executive directors, but for listed companies at least half independent non-executives. 	<ul style="list-style-type: none"> ▪ <i>Board composition:</i> a majority of non-executive and independent directors, but for listed companies a majority of independent directors. 	<ul style="list-style-type: none"> ▪ <i>Board composition:</i> a significant burden of non-executives and an adequate number of independent non-executive directors.
<ul style="list-style-type: none"> ▪ <i>Specialised committees:</i> (recommended) at least three committees, audit and remuneration entirely independent, while nomination with a majority of independent. 	<ul style="list-style-type: none"> ▪ <i>Specialised committees:</i> (obligatory) at least three committees (audit, remuneration and nomination/CG) entirely independent. 	<ul style="list-style-type: none"> ▪ <i>Specialised committees:</i> (recommended) at least three committees, audit and remuneration entirely non-executives with a majority of independent, while nomination with a majority of independent.
<ul style="list-style-type: none"> ▪ <i>Separation CEO/Chairman:</i> (strongly recommended) non-executive chairs, chaired by a senior independent director 	<ul style="list-style-type: none"> ▪ <i>Duality CEO/Chairman:</i> executive sessions, chaired by a lead independent director. 	<ul style="list-style-type: none"> ▪ <i>Separation CEO/Chairman:</i> (weakly recommended) otherwise executive sessions, chaired by a lead independent director.

Source: Authors’ elaboration.

4. The role of the outsider in the board of directors

Independent directors or *outsiders* introduce themselves into the difficult relationship between shareholders and managers. In fact, their presence on the board of directors is wished by all existing codes of best practice, because their basic role consists in protecting firm’s interests⁴⁶. On one hand,

⁴⁴ A review on the Italian boards composition is in Schwizer & Netti (2006). See also Allegrini & Bianchi Martini (2006), who compared the UK, US and Italy CG systems.

⁴⁵ In the Attachment 5-bis, issued by the Consob, art. 144-terdecies provides for a limit to cross-directorships, calculated on the basis of the company’s sector and the typology of task.

⁴⁶ Many economic reasons explain the existence of independent directors, as in particular the ownership structure. In fact, the separation between ownership and control, analyzed by Berle & Means in 1930s, is a point of reference for further studies yet. According to authors, as long as ownership and control are in one’s hand, the personal interest coincides with company’s one, but when there is a very fragmented shareholding (and a consequent separation between ownership and control) some conflicts of interest could appear and they could be reduced and/or eliminated by a certain number of independent directors on the board. See also Fama & Jensen (1983b), according to which an optimal structure of board requires the presence of both *inside directors* and *outside directors*, and outsiders just protect shareholders from potential conflicts of interest between principal and agent.

independence requirement itself is a guarantee for autonomy and objectivity of judgements; on the other hand, the internal control role entrusted committees with a majority of independent directors is a further important element to protect stakeholders⁴⁷.

As we'll observe later on, given the fundamental role of boards, especially their non-executive and independent directors, it's explained the increasing attention of both policymakers and researchers to the determinants of directors compensation. In literature there are many studies about CEO and executives compensation, while a few about outsiders compensation.

Outside directors⁴⁸ arose in the USA after financial scandals in the 1970s, in order to strengthen the management monitoring by boards. So an *audit committee* established and independent directors appointed. Gradually, board's power was reinforced. So the board of directors had to: include a majority of non-executive and independent directors, express itself on directors *hiring & firing* and executives compensations, determine corporate strategies, approve the related party transactions. Besides, in the US system, as recommended by laws and CG codes, *executive sessions*, chaired by a *lead independent director*, are frequent because of duality CEO/Chairman, and only non-executive and independent directors take part in these meetings, to discuss important questions without CEO and other executives influence⁴⁹.

In Europe, at first outsiders were introduced in the UK system, similar to the US one, and they obtained an official recognition by the Cadbury Report (1992), even if it restricted board's power to financial controls⁵⁰. Then, the Higgs Report (2003) extended the board's roles to corporate strategies, directors *hiring & firing* and executives compensations too.

Also in the Continental Europe, the Anglo-Saxon conception of the board's roles is successful more and more: boards not only have to administrate firms but also, and above all, monitor and control executives actions. In this sense, boards have a basic role because they have to realize a balance between management and supervision, that is just the meaning of CG, and among different interests of stakeholders.

So outsiders role of monitoring company's life becomes crucial: it's just upon their independence, as law or codes required, and their presence in an adequate number inside the board (and its committees), that credibility and reliability of management control base themselves⁵¹. Because of its Anglo-Saxon origin, outside director places itself on one-tier models in a natural way, while it's more difficult to understand if outsiders could be consistent with two-tier models.

In fact, CG systems actually are different across the countries. In the *one-tier model* or *outsider system*, typical of the Anglo-Saxon market-oriented systems⁵², boards have to administrate and control

⁴⁷ A review about theoretical studies and empirical results on outsiders role in general, without distinguish between *affiliated* and *independent* is in Fields & Keys (2003).

⁴⁸ A confusion between independent and non-executive directors is possible. On the board of directors there are two typology of members: executive and non-executive directors, and those non-executives which satisfy some specific personal requirements (defined by law and codes of best practice, so changeable across different countries) are considered "independent". But if it's true that a non-executive director can be independent and so independent director is also non-executive, however these two types of directors are different. The classification among *inside directors*, *affiliated outside directors* and *independent outside directors* is drawn by Baysinger & Butler (1985).

⁴⁹ In the UK, because duality presence is less evident, non-executive meetings are chaired by a *senior independent director*. Morck (2004) observed that meetings among independent directors, non-executive chairs, senior independent directors e committees made up by only independent, without the CEO influence, could increase the CG rationality and ethics and improve corporate performance. Besides, as Carretta et al. (2006) found, an average of 68% of the NYSE listed companies includes a lead independent director to chair executive sessions (and these executive sessions are diffused at 92% for the financial sector).

⁵⁰ Following the US example, first in the UK a self-regulation system stated, with the Cadbury Report (1992) that included no fewer than eight articles, from 4.10 to 4.17, for independent and non-executive directors.

⁵¹ All the CG codes include a section for independent directors, but the definition of independence and proportion of outsiders on the board vary across the countries, while nomination procedures and roles of independent directors are quite standardized. Also from an institutional point of view there are some differences: the OECD Principles (2004) recommended a sufficient number of non-executives to provide an independent judgement about potential conflicts of interest; according to the EU Recommendation (2005) a sufficient number of independent directors are necessary to protect shareholders interests. On the web-site of the European Corporate Governance Institute (www.ecgi.org) there is a complete list of the main CG codes. A comparison is also in Weil, Gotshal & Manges (2002), a study ordered by the EC to verify the opportunity of an "Euro-Code".

⁵² The Anglo-Saxon (USA, UK, Canada and Australia) CG model is characterized by: large companies with diffused ownership, an active and efficient capital market when many financial intermediaries operate, any interference of State in economics.

and so their executive directors manage while their non-executive and independent directors monitor. Therefore, outsiders are both in the board of directors and in the supervision organism, just to monitor effectiveness of control systems.

Instead, in the *two-tier model* or *insider system* there are two different organisms to administrate and control and this is the case of German and Japanese bank-oriented systems⁵³. In fact, in Germany there are a board of directors (*Vorstand*), responsible for company's management, and a supervision board (*Aufsichtsrat*), responsible for the board of directors nomination and control. Therefore, this second board has to include a sufficient number of independent directors and set internal committees.

In one-tier models, independent directors on the board are indispensable to ensure effective internal control systems; in two-tier models, outsiders aren't essential but their presence guarantees a correct management of company further on.

Finally, we would highlight that outsiders not only make up for troubles in the CG mechanisms and ensure company's interests, but also they increase corporate efficiency with their presence. Indeed, companies' efficiency, i.e. their correct functioning, is just the best guarantee and protection for all stakeholders, and it reduces risks of some particular interests' maximization. It isn't the outsider in itself to improve efficiency of the CK organisms, but its action of contrast against opportunistic behaviours of managers. So if outsiders have adequate skills and are in a sufficient number on the board, they could ensure efficiency and good performance of companies (Zahra & Pearce, 1989).

In the CG debate, directors' independence plays a central role and numerous scholars investigated the relationship between board's composition and firm's performance. Some authors (Hermalin & Weisbach, 1991 & 2003; Jensen, 1993; Yermack, 1996; De Andres et al., 2005) found that boards with few members provided a competitive advantage to firm, because they worked more efficiently, had well-defined responsibilities, and were likely to monitor by the CEO⁵⁴. Others found that, apart from size, board's efficiency also depended on the balance of executives and non-executives (Barnhart & Rosenstein, 1998; John & Senbet, 1998; McKnight et al., 2005), and the decision to dismiss not very efficient directors and so their probability of turnover were linked to the proportion of outsiders on the board (Weisbach, 1988; Hermalin & Weisbach, 1988 & 1998; Byrd & Hickman, 1992) and the separation of CEO and Chairman roles (Dedman, 2002; Dahya et al., 1998, 2002 & 2005). In addition, Shivdasani & Yermack (1999) found, when the CEO was directly involved in the appointment process, the board of directors included few independent outsiders; most of them had actually financial or personal relationships with the CEO⁵⁵.

However, with reference to the relationship between outsiders and corporate performance, authors conflicted. On one hand, some scholars (Baysinger & Butler, 1985; Cotter et al., 1997; Barnhart & Rosenstein, 1998; Beiner et al., 2006) highlighted a positive relationship between the outsiders presence on the board and a better performance of firm⁵⁶, because independent directors could dismiss

⁵³ The German and Japanese CG model is characterized by: large companies with concentrated ownership, smaller capital markets, a prevalent use of debt capital and banks participation at risk capital, a narrow relationship between State and firm. French and Italian models are similar to this one, but there are some differences. In particular, in Italy there are a lot of SMEs with a prevalent familiar management, few large companies with a restricted ownership (often by families), a smaller financial market, a prevalent use of self-financing and debt capital, a strength participation of State and local governments. Melis (2000) summarized the Italian CG system as follows: "*weak managers, strong blockholders and unprotected minority shareholders*". See Enriques & Volpin (2007) about the CG reforms in France, German and Italy. As Altunbas et al. (2007) observed, the Japanese CG system is characterized by: large industrial and financial groups (*keiretsu*), strength relationships between firms and the Japanese *main banks*, a strong involvement of institutional investors in ownership structure of the Japanese listed companies.

⁵⁴ In particular, as Jensen (1993) said, "*when boards exceed seven or eight people, they are less likely to function effectively and are easier for the CEO to control*".

⁵⁵ According to Carretta et al. (2006), a majority of non-executives, especially independent, isn't always a synonym of quality and objectivity of decisions, because the criteria by which are chosen directors and the substantial independency are more important. See also Santella et al. (2006 & 2007). Moreover, as Shivdasani & Yermack (1999) observed, when CEO is involved in the nomination procedure the market has a negative reaction, while market's reaction is positive when CEO isn't involved in it.

⁵⁶ For example, after observing that independent directors were responsible for the protection and promotion of small shareholders interests, Byrd & Hickman (1992) found a better performance in firms with a greater proportion (at least 45%) of independent outsiders on their boards, because the board's independency influenced market's behaviour. But, they also found this relation became negative when the proportion of independent outsiders increased over 60%.

the CEO after a poor performance⁵⁷ (Weisbach, 1988; Hermalin & Weisbach, 1988 & 1998; Byrd & Hickman, 1992) or because of a positive reaction of market when outsiders appointed⁵⁸ (Rosenstein & Wyatt, 1990; Mallette & Fowler, 1992; Brickley et al., 1994; Kang & Shivdasani, 1995; Borokhovich et al., 1996; Shivdasani & Yermack, 1999; Dahya et al., 2005; Petra, 2007). On the other hand, other authors didn't find any significant relationship between boards composition and firms performance (Hermalin & Weisbach, 1991 & 2003; Vafeas & Theodorou, 1998; Coles et al., 2001; Lin et al., 2003; De Andres et al., 2005; Weir et al., 2003). Moreover, some others (Cochran et al., 1985; Daily & Dalton, 1994; Agrawal & Knoeber, 1996; Yermack, 1996; Bhagat & Black, 1998; Dalton et al., 1998; Muth & Donaldson, 1998; Adams & Mehran, 2003; Fernandes, 2007) even found a negative effect on corporate performance because of the outsiders presence on the board⁵⁹. As Carretta et al. (2005) observed, we can explain these different results as a consequence of outsiders involvement usually during a crisis, and so independent directors are used to signal to the market company's transparency and internal control systems⁶⁰.

Apart from board's composition, corporate performance is influenced also by its organizational structure (for instance, its specialised committees and evaluation systems of the board, and meeting frequency and activity) and its directors skills and experience⁶¹. But, in this sense, there are few empirical studies in literature⁶². Carretta et al. (2006) investigated the USA companies listed on the NYSE and analyzed all the three aspects of boards above-mentioned (composition, organization and competences), concentrating their analysis on the independent outsiders competences. They found significant results about the old age of independent directors (60 and over), with a long experience and an economic-scientific education, and their length of service; in particular, the length of service was about 8 years on average, and it was over 10 years for about 25% of companies⁶³. Therefore, we can still talk about independence of outside directors? In fact, from a qualitative composition of boards viewpoint, independence seems to mean "*especially experience, not only professional, but also in the company's relationship*" (Carretta et al., 2006).

5. The Outsider Compensation Framework

5.1 UK Regulation

The awareness that the contribution of "good" company governance is important to the stability of the financial market, to investments and to the growth of the economy, has encouraged the international regulators to define an articulated and innovative set of general principles to stimulate Member States (and public listed companies) to go one step further from the simple compliance with the legal

⁵⁷ But when outsiders decide to dismiss the CEO because of a poor corporate performance, they also could be dismissed. On the contrary, they are rewarded by market for their decision. See Farrell & Whidbee, (2000).

⁵⁸ In particular, Petra (2007) found that, even if an high proportion of independent directors involved a better corporate performance, that wasn't worth when there were a separation of CEO and Chairman roles and entirely independent committees. Numerous authors (such as, for the Japanese companies Kang & Shivdasani, 1995; for the US companies Borokhovich et al., 1996; and for the UK companies Dahya et al., 2005) found a positive relationship between the proportion of outsiders on the board and the appointment of an external CEO, and that improved corporate performance.

⁵⁹ According to Fernandes (2007), there are some doubts about the real effectiveness of outsiders to align interests between managers and shareholders. He found, in fact, Portuguese companies (as one-tier system) with most of non-executives paid higher fees to their top-managers than companies without outsiders. This is a problem of un-real independency of outsiders, as Shivdasani & Yermack (1999), Carretta et al. (2006) and Santella et al. (2006 & 2007) observed.

⁶⁰ A review on different empirical studies about the relationship between board's composition and corporate performance is in Johnson et al. (1996), according to which different and contrasting empirical evidences derive by different measurement instruments adopted. See also Hermalin & Weisbach (2003), who define the board of directors "*an institution that has arisen endogenously in response to the agency problems inherent in governing and organization*".

⁶¹ An exhaustive review on the relationship between board (its institutional and structural characteristics, its organizational ones, and skills and experience owned) and corporate performance is in Carretta et al. (2005).

⁶² For example, as we previously mentioned, Protiviti (2005) and Schwizer & Netti (2006) analyzed the Italian case. For the Italian listed companies, see also Assonime – Emittenti Titoli SpA (2007). For the US companies see Agrawal & Knoeber (2001), who found also politics influenced the board's composition because outsiders with a political and legal experience played a key role in those companies where politics was relevant, while that wasn't worth if there were female directors.

⁶³ See Vafeas (2003) studied the influence of an excessive length of the outsider service, with particular regards to the remuneration committee.

standards to use governance as a competitive lever (OCSE, 2001 e 2004; European Commission, 2004).

On a broader plan, that of “modernizing” the board of directors of public listed companies, the guidelines also give attention to board compensations, which are not only a traditional incentive mechanism of the directors to “protect” shareholders’ interests, but also an instrument which recognizes the role and added value of the director’s contribution to the correct functioning of the board of directors. The emphasis on the skills and commitment that are asked of the directors can be justified with the objective of the regulators to induce the board of directors to change their purely bureaucratic and formal role and to become “guarantors” by gradually taking on a “central” role, together with the CEO (but in an independent position compared to the latter), when involved in the strategic decisions of the company. In this perspective, the remuneration of the board can almost be considered a “reward” for “productive” behaviour of the board of directors.

On recognizing the validity of the instrument of compensation, the Steering Group on Corporate Governance of the OECD promotes transparency, functionality and the quality of the company’s method. For example, the OECD recommends that public listed companies hand out the correct information with regards to the compensation given to directors and managers as well as the creation of a close correlation between these and the proxy of the contribution of the company advisor, calculated on a long-term basis. The regulators would release the information based on each individual case. This would be good practice, compulsory in various countries, to enable shareholders to control company policies, evaluating the costs and benefits of the rating systems as well as the incentives’ mechanisms (such as the stock option) based on the company’s results.

From the transparency point of view, even the European Commission, in its Recommendation on the encouragement of an adequate regime for the compensation of directors in quoted companies identifies the disclosure to the market as an instrument that strengthens the faith of the investor and guarantees healthy corporate governance at a European level. On the other hand, even the EC suggests that its Member States take the necessary precautions of shareholders when formulating the remuneration policy (total and individual) of the directors. The importance on information transparency is also emphasized by the suggestion of presenting a clear and complete account of the politics and the compensation level that each director has received. Such a document, attached to the annual budget, would in fact enable shareholders to evaluate and express their opinion with regards to the company’s reward strategies, exercising their right to vote on it at the company’s general meeting (European Commission, 2004).

At the international level, the Basel Committee on the banking supervision has recognized the usefulness of the principles of best practices on corporate governance even for banks and the relative control authorities, acknowledging the international guidelines with the appropriate modifications related to the singularity of each intermediary subject under examination (Basel Committee, 2006). The dispositions set forth by the Basel Committee support the laws, the regulations and the national codes that exist. They are also intended to facilitate bank organizations in honing in on the governance systems that are most suited for the size and complexity of any one company and well as the surveillance of the qualitative evaluation of such systems. By reasserting the fundamental elements of the governance principles - fully recognized by the financial market - the Basel Committee has identified in the sixth governance principle, the relevance of the compensation mechanism of the non-executives; this is the incentive needed to correctly carry out its own functions. Furthermore, it stresses the need to define a sum which is correlated to the responsibilities and commitment which are asked of the non-executives in terms of time (especially if the outsider is a member of the committee itself which is the case of audit committees and risk management), without being undeservedly linked to the results which the bank obtains in the short term.

In the United Kingdom, the Companies Act 2006 has an appropriate section on the compensation to the board of directors (Chapter 6, “Director’s Remuneration”), which forces a certain amount of disclosure by each company towards the market. This is also aimed at limiting the growth, often unjustified, of the board’s compensation⁶⁴. The directors of a quoted company must prepare a

⁶⁴ The Companies Act has received the dispositions for the remuneration of the boards as introduced in “The Directors’ Remunerative Report Regulations 2002”, Statutory Instrument 2002 No. 1986, available at: <http://www.opsi.gov.uk/si/si2002.20021986.htm>

Directors' Remuneration Report for each financial year of that company. The Report must be approved by the board of directors and signed on behalf of the board by a director or the secretary of the company. For each person who has served as a director of the company at any time during that year, the directors' remuneration report shows, for example, the total salary and fees paid to or receivable by the person with respect to the qualifying services; the total bonuses paid or receivable; the nature of any element of a remuneration package which is not in cash; the number of shares that are subject to a share option.

Similarly, the present UK Framework on corporate governance, based on the Combined Code and on the relative Guidance and good practices (which include the Guidance on Internal Control, the Guidance on Audit Committee and the good practice present in Higg's Report), promotes quality improvement, and not only of disclosure but of the organizational process which is at the base of the reward definition to the board of directors. To enhance the quoted companies' standing on the financial markets, the Combined Code validates the creation of an appropriate institution with the appropriate deciding body within the board, the remuneration committee (already presented in the Cadbury Code of 1992 and in Pro Ned's Remuneration Committee guidelines of 1992). This committee is only made up of independent non-executive directors with specific experience on the matter. The establishment of such a committee, as deputy organ for the definition of the remuneration policy for executives only, aims at: reducing the risk arising from the conflicts of interest, improving the quality of the remuneration policy and provide the shareholders and all interested parties with a guarantee. From the transparency point of view, instead, it is hoped that the principles contained in the Code will lead to a correct charge of the higher rewards given by the executives in the annual report, highlighting the different remunerative parts handed out by the company.

As far as the remuneration of the outsiders is concerned, even if the discipline declines the few general principles, the number of complexity elements increases when one considers the particular role of the "independent" which, in the one-side governance models, so widespread in the UK, is usually taken up by the outsider.

The Code, in fact, stresses the need for a reward level. It should be compatible with the board's contribution to the outsider, based on the time and responsibilities and also be appropriate to guarantee the possible independence acknowledged to the director. This feature presents evident fallouts on the structure of the rewards themselves, since resorting to mechanisms of the pay-performance type, for the independent outsider, could weaken his ruling impartiality at board meeting. For these reasons, the code recommends the use of remunerative mechanisms based mainly on cash. These exclude the involvement of the outsiders to stock options, pension or other long-term incentive scheme; however, if these are present, the shareholders at the general meeting of the company should approve such mechanisms.

The main principle dictated by the Combined Code in the remuneration section of the board, focuses on the compensations and suggests an amount that is *"sufficient to attract, retain and motivate directors of the quality required to run a company successfully, but a company should avoid paying more than is necessary for this purpose."*

As far as stipulating the compensation, the Combined Code confirms the importance of correlating this amount to the attention and expertise that each advisor gives the company, in terms of time and responsibilities taken on within the board of directors. Moreover, the discipline confirms the need of both greater control by the shareholders in the process which assesses the compensations and also the qualitative improvement of the process itself, by resorting to external advisors, capable of backing the executives in the definition of a "suitable" remuneration for the outsiders and, at the same time, to minimize the possible internal conflicts which could jeopardize the organizational framework of the board of directors.

Finally, the guidelines set out internationally, and the English codes of self-discipline with regards to corporate governance, recognize the importance of compensations to the outsiders for public listed companies and outline a correct definition process for these rewards: transparent towards the market, "controlled" even by the shareholders, free from company-performance but careful to recognize the importance of the commitment, the responsibilities and the specific abilities that are demanded of the role of the outsider on the board.

5.2 Literature Perspective and Hypothesis

The importance of the compensation of the board of directors is also confirmed by the numerous and diverse studies in literature. The topic is not only interesting, but also quite debated. The critical elements, with particular emphasis to the outsiders, can be found in the structure, the level and most important, those factors that determine these advisors' compensation. From the structural point of view, the aspect which is most discussed is the opportunity of predicting performance-related mechanisms even for the outsiders. Certain investigations on the matter have revealed that the opinion of the directors themselves is not the same (Clarke, Canyon & Peck, 1998). With regards to the level of compensations, the debate develops among those who believe it is necessary to give "interesting" compensations so as to attract even the attention on the strategic processes of the directors with high professional standing and those who, instead, support the need to recognize a minimum compensation fee, sufficient to recruit those outsiders who are truly interested and motivated in carrying out control and strategic support within the board (Mace, 1971; Fama & Jensen, 1983; Ward, 2006). The literature on the subject shows that there is no one clear method to determine or explain which factors are involved in the remuneration policy and the various procedures of listed companies, to determine the compensation of the outsiders.

The different approaches to this matter, as used in the various studies, justifies their classification in relation to the theoretical view of the analysis, as is done in Table III below.

Transversal literatures of Table I show that there are three different prospective theories to which factors affect the compensation of the board, namely: economic, social-psychological and social economic. The economic factor, of which there are the most studies, considers compensation as an instrument necessary to limit the opportunistic behaviour of the individuals in view of the agency's theory. From this point of view, compensation becomes the incentive for the board to mitigate the agency's problem between shareholders and management. The effectiveness of the incentive is based on the capacity of the compensation to adjust the interests of the board to those of the shareholders and therefore involves the use of performance-related mechanisms. Consequently, such studies analyse pay-performance showing, in certain situations, the absence of a causality link between the two variables (Leonard, 1990; Kerr & Bettis, 1987; Fernandes, 2007).

Table III – Theoretical perspective of literature on the compensation of the board.

Perspective/Theory	Inside Directors	Outside Directors
a) Economic Perspective		
▪ <i>Agency Theory</i>	Coughlan & Smith (1985); Ryan & Wiggins (2004); Canyon & Peck (1998); Eichholtz, Kok & Otten (2005); Fernandes (2007).	Linn & Martin (1998); Gerety et. Al. (2001); Ryan & Wiggins (2004); Fitch & Shivdasani (2006).
▪ <i>Agency Theory & Others (Resource- Based Theory, Labour Market Theory, Human Capital Theory, Marginal Productivity Theory, Contract Theory)</i>	Gomez-Mejia (1994); Finkelstein & Hambrick (1996) Gomez-Mejia & Wiseman (1997); Harris & Helfat (1997); Magnan & Stonge (1997); Ezzamel & Watson (1998); Gray & Benson (2003).	Boyd (1996); Yermack (2004); Linn & Park (2006).
b) Social-psicological Perspective		
▪ <i>Decision Theory; Equity Theory; Institutional Theory; Theory of Legitimacy; Contingency Theory; Managerial Power Theory</i>	Teversky & Kaheman (1974); Miller (1995); Finkelstein & Hambrick (1996); Barkema & Gomez-Mejia (1998); Finkelstein & Boyd (1998); Bebchuk, Fried & Walker (2002).	
c) Social-Economic Perspective		
▪ <i>Agency Theory; Executive power; Stewardship theories; Institutional Theory</i>	Bender (2003 and 2004); Bruce, Buck & Main (2005); Filatotchev (2006).	

Source: Authors' elaboration.

The poor results of pay-performance have forced the most recent studies to enlarge the theoretical perspectives of the agency's theories by adding or substituting it with other economic and managerial theories that can better explain the company policies and those factors which determine the compensation of the board. Finkelstein & Hambrick (1996) and Gomez-Mejia & Wiseman (1997) suggest the labour market theory, and argue that the board of director's pay can be explained in terms of the supply and demand for directors. In this context, Ezzamel & Watson (1998) refer to the need to pay the "going rate" to the board of directors, so as to motivate and keep them. Boyd (1996) combines resource-dependence theory to agency theory to develop an explanatory model of director compensation. He reports that firm size, firm profitability, director stockholdings and resource wealth are significantly related to outsider compensation. Gray & Benson (2003) report a significant effect of human capital, organizational size and organizational affiliation on the executive compensation in the non-profit business firms.

At the same time, the criticisms made to the economic issue related to hiring are, for example, the opportunistic behaviour of the economic agents; the use of the company as a straightforward link to contracts; or that the linearity of the decisional process of the company gives rise to an alternative analytical perspective, of the socio-psychological type, which interprets the definition process of board compensation in relation to existing psychological motivations of the economic agents and the social links between them. DiMaggio & Powel (1983) propose the institutional theory, and consider the isomorphic pressures that influence companies to act in a similar manner. Such pressures may arise due to regulators, or due to imitation of the best practice, or be passed on through the professional practice of external advisors. Gomez-Mejia & Wiseman (1997) highlight the relevance of the legitimacy theory in the directors' remuneration. They suggest that one reason companies adopt compensation practices that are widely accepted in their industry is to gain legitimacy. Barkema & Gomez-Mejia (1998) say that the use of external remuneration advisors can also be seen as a legitimising device. Adams (1963) and Miller (1995) suggest the equity theory and argue that employees consider how hard they work (input) and how much they get paid (output) and compare that ratio to a referent, such as another employee or an individual in a similar company. Tversky & Kahneman (1974) consider the anchoring-and-adjustment related to the decision theory; from this perspective, they imply that people usually make numerical estimates by starting from an initial value (just the anchor) and adjusting it until it yields a final answer. The relevance of this to board compensation is that remuneration committee or executives often have a figure given to them as a starting point, such as the previous years' pay or a salary survey, and their judgment may be correlated to this. A further explanation in this perspective's analysis is the contingency theory. Balkin & Gomez-Mejia (1987), Barkema & Gomez-Mejia (1998), Finkelstein & Boyd (1998) argue that the remuneration policies for directors should reflect the company's overall strategy. If they do not, the lack of fit is likely to impede the effective implementation of the firm's strategy.

More recent studies show how the two previous points of view, if considered individually, come to limited conclusions (Bender, 2003). The complexity of the subject, on the contrary, can justify a multi-disciplinary approach of the analysis, one that can integrate the two perspectives (socio-economic) to highlight the presence, in real life, of economic and social interests, which are the key points in setting the compensation of the boards. In line with socio-cognitive and behavioural research, Filatotchev (2006) shows that the incentives of outsider directors are negatively associated with the experience and power of executive directors, and that large-block share ownership is positively associated with the intensity and diversity of outsider's experience. Bruce, Buck & Main (2005) discuss the interlinked nature of three available theoretical lenses (principal-agent, executive power and stewardship theories) to better comprehend development in executive pay.

Apart from the theoretical approach used, Table I also shows how the compensation studies of companies that are quoted on the Stock Exchange do not take into account the individual's profile. The few studies that are available on the subject concentrate on a sample of public industrial companies. These have prevalently used the agency theory construction. They try to explain the compensation levels using "algorithmic" models based on the company's properties (size and profitability), of the board (dimension and composition), and the amount of work that is required of the director (number of board meetings). Hempel & Fay (1994) report that, for USA corporations, compensation is mainly correlated with board size and meetings, but it is not related to company performance or CEO compensation. Boyd (1996) reports that firm size, firm profitability, director

stockholdings and resource wealth are significantly related to outsider compensation. Cordeiro et al. (2000) suggest that corporate boards are paying directors on the basis of some reasonable criteria and norms and so they are setting up systematic director pay systems. Linn & Martin (1998), Gerety et al. (2001) and Fitch & Shivdasani (2006) investigate security price revaluating surrounding the adoption of equity-based incentive pay plans for outside directors, while Ryan and Wiggins (2004) examine the influence of board independence during the year 1997. Even if punctual and rigorous in terms of the scientific profile of the calculations, such studies limit themselves to evaluating the adequacy of the outsiders' compensation based on "objective" work variables and not focussing on the necessity, as highlighted by the same self-discipline codes, that the remuneration level which also varies according to the professional profile and the experience acquired the person covering such a role.

Those studies, which do not take into account the "personal" characteristics of the outsider, can only present partial results with regards to remuneration policies and practices used by the public listed companies.

Based on the results of the previous studies, the analysis developed in this study uses a multi-disciplinary approach. This integrates the economic vision of the human capital theory with the psychological view of the equity theory to identify possible new determinants for the outsiders' compensation, which are also coherent with the dispositions of the codes of self-discipline on governance. Such a view supports the authors' conviction that the compensation levels are strictly dependent on the outsider's characteristics, such as, for example human capital, as well as the peculiarities of the board and of the governance mechanisms used by the company, and the company's own peculiarities.

What follows is a detailed presentation of the different hypotheses on which this study is based.

The human capital theory (Mincer, 1974; Becker, 1993) stresses the importance of the individual worker's profile and explains the differences in salary which have been found on the work market based on the human capital of the individual (measured by differences in skill, ability, experience, knowledge or other characteristics that might affect performance). Finkelstain & Hambrick (1996) report positive impact of managerial experience on CEO pay. Schwalbach & Brenner (2001a) found that the managers' level of education and experience has a positive effect on compensation. Schwalbach & Brenner (2001b) report a strong relationship between firm size, managerial talent and director compensation in a German sample. Gray and Benson (2003) support the significant effects of human capital on the executive compensation in small businesses. So, from this study it was expected that the human capital of outsiders would have affected their compensation level. More experienced outsiders can be expected to perform better, and hence lead their organization to a higher performance level. Otherwise, highly qualified directors may demand a premium from labour market because they have more employment opportunities elsewhere. With reference to the experience of the outsider, the international best practices and certain studies on this matter highlight that the outsider needs to not only be independent, but also competent, gifted of international skills, specific professional expertise and sector knowledge. All these characteristics enable the outsider to carry out not only a control role, but also one of strategic consultancy within the board (Treichler, 1995; Spencer Stuart, 2003). With regards to the industry-specific experience, the best practices emphasize the relevance of an adequate know-how, which avoids having a duplication of roles within the executives. Fama (1980) and Fama & Jensen (1983) suggest that a board with a more reputable outsider, with high human capital level, is better than other boards at monitoring managers more effectively because they have substantial reputation capital at stake.

Other studies highlight that there are other factors which link compensations to other characteristics of the outsider, such as gender and the outsider's board position. Preston (1989) reports a smaller gender effect on compensation in non-profit than for-profits; Leete (2001), confirms a slightly positive differential for females in non-profits. By contrast, Kesner's (1988) results do not detect significant gender differences between compensation committee members and non-members, suggesting that women directors are not window-dressing, but hold important positions on corporate boards. Hempel and Fay (1994), as Cordeiro et. al. (2000), argue that the compensation of the outsider is significantly correlated to director effort, such as responsibilities and time commitment. Another important determinant of the outsider compensation is the length of service in the firm. There are conflicting results about the true impact of this variable. Kosnik (1990) says that that longer director length of service the greater the director's expertise, and this enhances the outsider's effectiveness on the board.

On the other hand, Wallace (1987) suggests that directors with excessive length of service in a company become too complacent towards management. These studies highlight the relevance of the length of service and also that its impact on the outsider compensation is not clear. So, we expected that:

H1: Outsider compensation is positive related to the outsider's profile: human capital (experience and popularity), gender, responsibilities, meeting activity and length of service in the firm.

The agency's theory highlights how the characteristics of corporate governance structure affect the remuneration of the boards (Fama & Jensen, 1983). Moreover, certain analyses confirm how the directors' compensation is related to properties that are specific to the boards. Hempel & Fay, 1994 show a relationship between the size of the board and the compensation received by the outsiders.

With regards to the way the board is made up, Watson et al. (1993), Carver (2002) and Schippers et al. (2003), suggest that diversity is necessary to assure a broad base of wisdom so, boards made up of qualified directors who reflect a diversity of experience, gender and ethnicity, take advantage of their differences to work successfully together for the company. Huse and Rindova (2001) and Catalyst (2004) show how the diversity of the board can improve the presence of the different categories of shareholders, and therefore safeguard their interests within the board of directors. On the other hand, De Andrei et al. (2005), Dulewicz & Herbert (2004) show how the board's diversity does not have any beneficial effect on the performance of the companies. Although the evidence on the benefits of diversity on the quality of the board, and thus on the companies' performance are controversial, there is the hypothesis that there is a relationship between diversity and outsider compensation.

Contrary to other studies, one assumes that there is a relationship between the singularity of the process, which defines the compensations of the outsiders, and the compensations themselves. At present, in this area, one is investigating on: the contribution that a formal board evaluation process might bring to the level of compensations, if developed by an advisor who is external to the company; the impact that the role has on the definition of the compensations on the rewards themselves if acknowledged by the shareholders rather than only by the executives; the effect that the use of performance-related instruments could have on the level of compensation of the outsiders.

Another element, which could positively influence the compensation of the outsider, is the dualism between CEO and Chairman, which, by acknowledging within the company greater decision powers to the CEO, can induce the person to develop an opportunistic behaviour in determining the compensation of the outsiders.

So, we expected that:

H2: Outsider compensation is related to board size, CEO duality, structure of outsider compensation and external board evaluation.

The equity theory claims that the social relationships are defined by fair and balanced exchanges between individuals, based on the rule of reciprocal exchange in society, and shows that in those situation where compensation to these people within the company has been too high or too low, they become frustrated and fairness is restored by redefining their own role of cost/benefit. In this case, to avoid dissatisfaction building up within the boards, there must be a link between the compensation, which the CEO receives, and that which the outsiders to the same company are given. A few authors (Ward, 2006) suggest that the level of compensation of the outsiders has to be commensurate to that which the CEO is given, and that it can be determined very easily by multiplying the daily value of the remuneration of the CEO by the commitment of the outsider in the company as expressed in days. By confirming that there is a relationship between the compensation of the CEO and that of the outsider, Crystal (1991) and Lublin (1991) claim that executives and CEOs agree to increase the compensation of outsider directors in exchange of increased top executive compensation. On the other hand, Hempel and Fay (1994) do not find any correlation between the CEO and the outsider's compensation. So, we expected that:

H3: Outsider compensation is related to the CEO annual level of compensation.

The studies that investigate on the factors affecting the compensation of the executives highlight that there are certain relationships between the size of the company and the level of compensation (Brenner & Schwalbach, 2001). Other studies similarly show that there is a correlation between the performance of the company and the level of compensation of the executives (Morck et al., 1988; McConnell and Servaes 1990; Frye, 2001). Moreover, certain empirical facts support such notions even for outsiders' compensation. Boyd (1996) reports that in a US sample, the outsider compensation depends on firm size and firm profitability. Eichholtz, Kok & Otten (2006), document that company size is the most important variable in explaining the level of director compensation. Brick et al. (2002), report a link between firm "underperformance" and "excessive" compensation for managers and directors. For these reasons, the model presented here uses size and profits as control variables. Finally, one assumes that there are inter-industry differences when one considers the singularity of the bank and finance sectors compared to other ones. So, we expected that:

H4: Outsider compensation is related to the size, profitability and the industrial sectors of the firm.

6. Methodology and Variables definitions

Multiple regression analysis using the Ordinary Least Squares (OLS) has been used.

First of all, the regression analysis considers those variables that have been identified in previous research, namely those that determine compensation. It develops further models by introducing and testing the relevance of the variables built up in this study to improve the predictive ability of the regression.

Before using the multivariate analysis, descriptive statistical instruments are used to gather the general properties of the sample. In this area, the two t-test samples with equal variance, created on certain variables allow to recognize the possible input of the regression when explaining the variability of the outsider's compensation.

The model used in the regression analysis is, in general, of the log-linear type. In certain cases, even the regressor is expressed on a logarithmic scale resulting in a log-log type model. In yet other cases, it takes on a binary form, while in the others a continuous one.

The dependent variable in the multivariate regression model is the logarithm of the year 2005 outsider total cash compensation. The components of outside director compensation used in the model only include cash retainers and fees paid by the company and leave out equity-based awards such as shares, stock options and stock grants, restricted stock and deferred stock⁶⁵.

The independent variables used in the model are the outsider determinant compensation as anticipated by the research hypothesis. For ease of presentation, these have been grouped together in relation to the three different analytical profiles: outsider, board and company.

More specifically, the outsider's profile is defined by gender and specific individual properties, such as the role and the responsibilities taken on within the board, the time devoted to the company in terms of participation to board reunions and to other committees, and the human capital of the outsider. The latter is estimated in terms of the outsider's professional popularity experience.

The experience of the outsider is, in turn, expressed on two analytical levels. The first, defined as the general level of experience, which coincides with the age of the directors. The second, defined as the industry-specific level of experience, which measures the degree of know-how the outsider has in the industrial sector of the company in which he/she is hired and corresponds to one of three profiles. *Specialist*, if the director only has professional experience in the area of the company. *Expert*, if the director also has professional experience in other fields that differ from those of the company being served⁶⁶. *Generalist*, if the director has not in the past worked in the area of that company.

⁶⁵ In the case of the directors' total compensation is reported in American dollars, the 2005 average rate USD/GBP is used to convert the director compensation in GBP.

⁶⁶ In this profile, the author makes all the outsiders who belong to the sample with an academic or political role.

The second variable used as a proxy of the outsider human capital is represented by the person's popularity⁶⁷. This is expressed as the number of times the outsider's name appears on general and financial papers in the United Kingdom during the two years prior to entering the company⁶⁸.

With reference to the properties of the company's board, the following have been examined: the structure, in terms of total number of directors; the composition, in terms of the presence of independents on the board and the diversity of the board (gender and nationality of the outsider) measured using Blau's Index (Blau, 1977; Finkelstein & Hambrick, 1996; Carpenter, 2002; Ruigrok et al., 2006)⁶⁹; the organization, in terms of disclosure of the presence within the company of the CEO's duality, the presence of an external advisor in the process of board evaluation, of using pay-performance instruments to determine compensations, total annual compensation received by the company's CEO during the year in observation.

Lastly, with respect to the characteristics of the company, the variables reveal to which industrial sector these belong⁷⁰, the size (total asset, number of employees and market capitalisation), the profitability (ROE). These are the control variables in the regression model.

Hence, the model of multiple regression with a linear regression function which has been used in this study can be expressed with the following general formula:

$$\begin{aligned} \text{Ln}(Y)_i = & \alpha_0 + \beta_f \text{CeoDu} + \chi_f \text{CeoComp} + \delta_f \text{Blau} + \sigma_f \text{Extboard} + \eta_f \text{Shareop} + \\ & + \sum_{c=1}^3 \zeta_{ic} \text{BoPosit} + \phi_i \text{Lenght} + \varphi_i \text{MeetAct} + \nu_i \text{Pop} + \omega_i \text{Auditme} + \rho_i \text{Chairm} + \tau_i \text{GenExp} + \\ & + o_i \text{Gender} + \sum_{d=1}^2 \psi_{id} \text{IndExp} + \sum_{e=1}^2 \gamma_{fe} \text{IndFirm} + \kappa_f \text{LnRoe} + \lambda_f \text{LnTAsset} + u_i \end{aligned}$$

where:

$i = 1..n$, with $n = 233$ is the number of the outsiders who belong to the sample being analysed;

$f = 1..m$, with $m = 40$ is the number of the firms in the sample;

$\text{Ln}(Y)_i$ represents the logarithm of the variable which depends on i -th director;

α_0 represents the constant of the model;

$\beta_f \text{CeoDu}$ is a dummy variable about the presence of the Ceo Duality case in the f -th firm of the sample; it is equal to 1 if a Ceo is also a Chairman of the firm, otherwise it is equal to zero;

$\chi_f \text{CeoComp}$ is the logarithmic of the Ceo annual total cash compensation of the f -th firm;

$\delta_f \text{Blau}$ is the Blau's Index, a percentage of the board diversity (gender and nationality of directors in the board);

$\sigma_f \text{ExtBoard}$ is a dummy variable about the presence of the advisors in the board evaluation process of the f -th firm; it is equal to 1 if the board evaluation process is released by an advisor, otherwise it is equal to zero;

$\eta_i \text{Shareop}$ is a dummy variable about the structure of the outsider compensation in the firm; it is equal to 1 if the outsider compensation is performance-related, otherwise it is equal to zero;

$\sum \zeta_{ic} \text{BoPosit}$ is a dummy variable about the i -th outsider position in the firm, with $c = 1$ to 3 like the number of the dummies ($c = 1$, chairman position, $c = 2$, independent non-executive position, $c = 3$, senior independent position); so, the general reference of the variable is the non-executive director;

$\phi_i \text{Lenght}$ is the Length of service in the firm of the i -th outsiders;

⁶⁷ The evaluation of popularity of individuals is usually used in political circles in order to determine the potential of the candidature in winning the political elections in a Country. See Mueller, 1970 for example.

⁶⁸ Among the publications used, those worthy of mention are: The Times, Financial Times, The Independent, The Guardian, The Business, AFX UK Focus, The Daily Express, The Sunday Times, The Scotsman. The information obtained via published news, recurring information on company quotations and on the market, on necrologies, on sports and calendar have been excluded.

⁶⁹ We calculated Blau's Index (B) as:

$$B = \left(1 - \sum p_i\right)^2$$
 where B is the heterogeneity measure and p_i is the percentage of board members in the i -th group (i.e. nationality, education, gender). The higher the value of B, the greater is the heterogeneity on a particular variable, Ruigrok et al. (2006), p. 133.

⁷⁰ To simplify the analysis and the comment of the results, in certain cases the six industrial sectors have been grouped into the following three: banking and financial services, hi-tech (made up of companies in the aerospace, technology hardware and technology software areas), pharma & biotech.

Φ_i MeetAct is the ratio between the number of the board/committee meeting attended by the i-th outsider in the 2005 and the total board/committee meeting of the firm in the 2005;

v_i Pop is the measure of the popularity of the i-th outsider, calculated like the times in which the outsider's name was published on the general and financial UK journals and newspapers in two years before his nomination in the firm;

ω_i Auditme is a dummy variable about the presence of the i-th outsider in the audit committee of the firm; it is equal to 1 if the outsider is also member of the audit committee, otherwise it is equal to zero;

ρ_i Chairm is a dummy variable about the position of the i-th outsider in the firm; it is equal to 1 if the outsider is also chairman of the board or one of the committee in the firm, otherwise it is equal to zero;

τ_i GenExp is the general experience of the i-th outsider measured by the age of the director;

o_i Gender is a dummy variable about the gender of the i-th outsider; it is equal to 1 if the outsider is a female, otherwise it is equal to zero;

$\Sigma \psi_{id}$ IndExp is a dummy variable about the industry-specific experience of the outsider, with $d=1$ to 2 ($d=1$ is the specialist outsider, if the i-th outsider has worked only in the industry sector of the firm in the previous years; $d=2$ is the expert outsider, if the i-th outsider has worked also in the industry sector of the firm in the previous years); so, the general reference is the generalist director profile, the case in which the i-th outsider has not worked in the industry sector of the firm in the previous years;

$\Sigma \gamma_{fe}$ IndFirm is a dummy variable about the industry sector of the f-th firm, with $e=1$ to 2 (where $e=1$, hi-tech sector; $e=2$, bank & financial sector); so, the general reference in this case is the pharma & biotech sector;

κ_f LnRoe is the logarithmic of the 2005 profitability of the f-th firm;

λ_f LnTa is the logarithmic of the 2005 Total Asset of the f-th firm;

u_i is the error of the model.

Table IV is the description and synthesis of the variables used in this analysis.

Table IV – The Outsider Compensation Drivers.

<i>Outsider Compensation's Drivers</i>	<i>Variables</i>	<i>Descriptions</i>	<i>Mesures</i>
1. Outsider's Profile	Gender	The gender of the outsiders in the board.	Dummy
	(Outsider Role)		
	- Board Position	The outsiders' position: Chairman, NED, Independent NED, Senior Independent.	Dummy
	- Responsibility	If the outsider is also chair/membership in a committee.	Dummy
	(Outsider Effort)		
	- Length of Service	How much time the outsider is in the firm.	Years
	- Meeting Activity	No. of attendance board/committee meeting of the outsider divided by the total no. of the firm's annual board/committee meeting.	No. of attendance meeting
	(Outsider's Human Capital)		
	- General Level of Experience	Outsider's age.	Age
	- Industry-Specific Level of Experience	If an outsider has worked only/also/not in the industry sector of the firm in the previous years.	Dummy
- Popularity	Times in which the outsider's name was published on the general and financial UK journals and newspapers in two years before his nomination in the firm.	Published outsider's name	
2. Board of Director's Characteristics	(Board Structure)		
	- Board Size	No. of executive and non-executive directors.	No. of directors in the board
	(Board Composition)		
	- Board Diversity	No. of females and foreignness directors in the board.	Blau's Index
	(Board Organization)		
	- CEO Duality	If the CEO is also the Chairman of the firm.	Dummy
	- External Board Evaluation	If an external advisor evaluates the board of the firm.	Dummy
- Structure of outsider compensation	If the compensation is based on cash and shares, stock options, stock grant.	Dummy	
- 2005 CEO Total Compensation	Total retainers and fees paid from the society, include equity-based awards, like shares, stock options, stock grants, restricted stock and deferred stock.	Logarithm of £	
3. Firm's Characteristics	- Industry Sectors	Banks, Financial Services, Aerospace & Hi-tech, Pharma & Biotech.	Dummy
	(Control Variables)		
	- Size	Total Asset (Ta), No. of Employees, Market capitalization.	Logarithm of Ta; Logarithm of No. of employees; Logarithm of Market capitalization
- Earnings	Roe	Logarithm of Roe	

7. Sample and Data

The sample is made up of 233 outsiders⁷¹ from 40 English public listed companies⁷²

Apart from the banking and financial sectors, other industrial sectors with high complexity and wide business diversity were included in the sample so as to determine the relevance of the outsider human capital in such industrial situations, as well as possible differences/analogies with regards to the remuneration of the board.

To this end, the first ten companies per market capitalization present on the FTSE-350 index of 15 March 2007 were chosen. These belong to the areas of banking, finance, pharma & biotech, aero & defence, technologies hardware and software. The sample represents: 100% of the FTSE-350 Banks, 88% of the FTSE-350 Financial Services, 100% of the FTSE-350 Aero & Defence, 100% of the FTSE-350 Pharma & Biotech, 100% of the Technologies Hardware & Software. All in all, the sample represents 30% of the FTSE-350 (See Table V).

Table V – Sample.

Industrial Sectors	No.	% FTSE-350	% FTSE-350 Industrial Sectors
Bank	9	18	100
Financial Services	10	2	88
Aero & Defence	8	2	100
Pharma % Biotech	4	7	100
Tech Hrd & Sft	9	1	100
Total	40	30	-

The data on the profile of the directors, the characteristic profile of the board and the organizational mechanisms of corporate governance present within the companies were taken from each company's 2005 balance sheets. Data on the popularity of the outsiders was obtained through the Factiva database. The economic data, relative to the profile of each individual company was instead obtained from the Bloomberg database. The verification of the hypothesis and the regression analysis was carried out using STATA version 9 software.

8. Results

Descriptive Statistics

Turning our attention to the entire sample, Table VI explains the descriptive statistics (mean, standard deviation, median, minimum and maximum values).

With reference of the outsider's profile, the human capital proxy highlight a level of experience which is quite high for those who are about 59 years old and this coincides to a large extent with the distribution median, with a relatively reduced variability of about seven years. The expert outsider (senior) within the sample is 75 years old. The data on popularity highlights that, on average, the prestigious outsider has been mentioned 23 times by name, with a variability of about 30 and a range of values which spans from a minimum of one to a maximum of 147 times.

From the outsider-effort point of view, the length of service in the company is on average four years.

⁷¹ To homogenize and complete the survey, the profile of the outsider includes, apart from the non-executive director, the independent non-executive director, the senior non-executive director, the senior non-executive director and the non-executive chairman director present within the board of the public companies belonging to the sample.

⁷² In the case of multiple directorships detected in the sampling, the counsellor appears only once in the sample, in the first company on which the consensus has been specimen.

Table VI – Descriptive statistics.

Regressors	Mean	SD	p50	Min	Max
1. Experience	58.622	6.779	59.000	39.000	75.000
2. Popularity	23.124	30.743	10.000	1.000	147.000
3. Length of service	4.137	3.853	3.000	0.500	26.000
4. Meeting Activity	14.438	5.483	14.000	0.000	29.000
5. Outsider Compensation	74.865	63.917	56.000	4.000	487.000
6. Board Size	12.318	2.864	12.000	5.000	17.000
7. Blau's Index	0.133	0.176	0.071	0.000	0.735
8. Ceo Compensation	1,753.828	1,187.773	1,400.000	229.000	6,591.000
9. Total Asset	200,177.893	445,416.167	9,292.000	90.000	1,860,758.000
10. Ftse-350	0.952	1.503	0.187	0.018	5.789
11. Roe	24.131	15.031	20.780	1.700	71.790
12. No. of Employees	38,990.682	62,575.264	7,296.000	76.000	265,285.000

On this point it is worth mentioning that the highest value of the distribution is 26, which emphasizes the practice of certain companies of identifying in the figure of the outsider (usually even an independent) previous company executives. Half of the directors in the sample have an “active” position on the board, in terms of meeting activities, 14, with an analysis of variance reduced or equal to five. The range of values spans from zero (for a non-executive nominated on the company board during the year of observation) to 29 annual meetings.

The average compensation level given to the outsider is of about 75,000 GBP, with a significant variance of 64,000 GBP, which is justified by a range of distribution values which varies from a minimum of 4,000 GBP to a maximum of 487,000 GBP. The average annual English compensation is higher, for example, to the annual Italian mean, where directors who do not belong to committee members receive 51,000 GBP. It is instead in line with the mean annual compensation received by Italian independent directors who do not hold a role within the committees (Spencer Stuart, 2006).

Looking at the characteristic profile of the board, the size is of 12 directors (considering the executive and non-executive ones) and represents a distribution which spans from a minimum of five to a maximum of 17 directors. The board diversity, in terms of gender and nationality, is around 13% of the total number of board members, the minimum value range, equal to zero signals the tendency – not yet used on a large scale – of creating board of directors that are “different”, contrary to the best practices used which are widespread at international level.

The companies, which belong to the sample, have a mean size in terms of total asset equal to 200.177 million GBP, a mean profitability in terms of ROE of 24%, the number of employees equal to 38.990 and weigh about 1’1% on the FTSE-350.

The analysis of the sample, based on the descriptive statistics, can be completed with the segmentation by industrial sector (bank & financial service, pharmacy & biotech, aerospace & hi-tech), in order to highlight further general properties (Table VII).

Table VII – Level of the experience and compensation of the outsider in different industrial sectors.

Industrial Sectors	General Experience (years)	General Experience (SD, years)	Compensation (Mean, GBP)	Compensation (SD, GBP)
Hi-tech	58	7	51,000	48,000
Bank & Financial Services	58	7	92,000	70,000
Pharma & Biotech	60	6	74,000	55,000

Table VII shows how the level of experience of the outsiders present on the board is to a large extent analogous within the different sectors and equal to 58 years, with a limited variance. On the other hand, the data on the mean compensation of the outsiders show considerable differences. On the board

of banks and financial companies the average compensation of the outsiders is around 92,000 GBP with a variability, which is significantly high, and equal to 70,000 GBP. On the board of pharmaceutical companies, the outsiders receive about 74,000 GBP with a variability of around 55,000 GBP; while on the board of hi-tech, aerospace and defence companies the level of compensation is lower than the previous ones, being of 51,000 GBP, with a variability of about 48,000 GBP.

The results of the t-test carried out on certain independent variables of the multivariate regression model have enabled a preliminary screening of the retribution mechanisms of the board.

Table VIII summarizes the results of the 11 sample t-tests with equal variances carried out and show the variables which have been used in the test, the averages sampled in terms of logarithm and GBP, the standard error, the t-statistic value and, finally, the acceptance or not of the null hypothesis with a confidence level of 5% and 231 degrees of freedom.

Table VIII – Results of two-sample t-test.

Variables	Mean (GBP)	Mean (ln)	Std. Err.	Degree of Freedom = 233	
				t – value	$H_0 = \mu_1 - \mu_2 = 0$; $H_1 = \mu_1 - \mu_2 < > 0$
Female (30)	46,841	3.846	.1408	-1.512	Non Reject H_0
Others (203)	58,405	4.067	.0521		
Board Chairman (25)	155,537	5.046	.1064	-8.050	Reject H_0
Others (208)	50,292	3.917	.0468		
Independent NED (144)	50,582	3.923	.0543	3.047	Reject H_0
Others (89)	68,423	4.225	.0942		
Senior Independent (34)	53,693	3.983	.1176	0.468	Non Reject H_0
Others (199)	57,312	4.048	.0538		
Board/CommitteeChair (104)	67,644	4.214	.0738	-3.277	Reject H_0
Others (129)	49,288	3.897	.0630		
Specialist (62)	60,342	4.100	.0975	-0.749	Non Reject H_0
Others (171)	55,527	4.016	.0567		
Expert (114)	55,306	4.012	.0652	0.520	Non Reject H_0
Others (119)	58,207	4.064	.0729		
Generalist (57)	55,970	4.024	.1100	0.164	Non Reject H_0
Others (176)	57,030	4.043	.0544		
Audit Member (142)	51,571	3.942	.0526	2.474	Reject H_0
Others (91)	65,946	4.188	.0930		
Ceo Duality (17)	47,081	3.851	.0511	1.071	Non Reject H_0
Others (216)	57,611	4.053	.1682		
Shares/Options (36)	69,439	4.240	.0544	-1.765	Non Reject H_0
Others (197)	54,717	4.002	.1039		

NOTE = In parenthesis, the frequency of the each variable in the sample.

With regards to the variables related to the outsider's profile, the t-test results show how the compensation does not vary in relation with the gender of the outsider, to the position of the senior independent director, to the level of industry-specific experience, which helps determine the counsellor's human capital.

As far as gender is concerned, descriptive statistics point out how, on average, outsider women receive a level of compensation that is in the order of 46,841 GBP less than that of outsider men, which is of 58,405 GBP. However, if one considers the distribution of the sample on the whole, the gender of the outsider does not appear to be statistically significant in explaining the variability of the compensation

that the outsider receives. This result is in net contrast with Gray & Benson (2003) who showed that there were substantial differences based on gender in the case of executives in small American business developments.

With reference to the position on the board of the director, in the case of the senior independent, the average compensation does not differ from that of the outsiders who do not have a role on the board. In the same way, the industry-specific experience level does not have an influence on the variability of the compensations of the outsider (the null bi-directional hypothesis on the coincidence of the two mean samples is accepted) confirming how the public listed companies, irrespective of the industrial sector, do not acknowledge the higher compensation of the industry-specific outsider. To this end, it is worth mentioning that the presence of generalists within the board, in contrast to some best practices set out internationally, could justify the absence of correlation between the presence of independents on the board and the companies' performance (Hermalin & Weisbach, 1991; Bhagat & Black, 2000).

The regressors pertaining to the outsider's profile which, based on the t-test results, influence the variability of the compensations to the outsider are: the position of the Chairman of the board, the position of the independent non-executive, the membership of the director to the auditing committee of the company. However, while in the first two instances the relationship has been shown to be positive, in the latter it is negative.

Going on to the regressors of the characteristic profile of the board, the results of the t-test reveal the absence of variability for the compensation of CEO duality within the company and in those situations where the structure of the compensation is based on the pay-performance mechanisms.

The correlation between the different variables of the model allow for further details to be gathered on the retribution dynamics of the outsiders and on the governance assets which are typical of the industrial sectors considered in this study⁷³.

The outsiders on the board of English banks are the highest paid compared to those on hi-tech and pharmaceutical boards. The former often receive compensation that is performance-related. Moreover, banks are larger in terms of total assets compared to companies in the other sectors, and are also characterized by larger sized board with the largest number of independents. The bank boards present also the highest degree of diversity and the largest presence of expert outsiders, at the expense of specialists. On the contrary, in the hi-tech sector there is the least diversity, in terms of a single woman, compared to the pharmaceutical sector.

The greatest board diversity is associated to the most profitable companies, thus confirming the benefits that have been presented by various authors (Huse and Rinnova, 2001; Catalyst, 2004). It is, moreover, also linked to fewer meeting activities of the directors and to a larger sized board.

Compared to the different roles of the outsiders on the board, the largest compensation is received by non-executive chairmen, a role which is predominantly carried out by men, with greater popularity and experience in terms of age. Men with high experience (age) usually have the role of senior independent director. Instead, the correlation between the different levels of industry-specific experience and the compensation does not seem to be statistically significant.

Multiple Regression Analysis

Starting from the results of the descriptive statistics, the regression model is built in various steps. It is set to verify the statistical relevance of the traditional variables presented in previous studies on outsiders' compensation, and the variables of this study. In certain cases, in consideration of the high multi-collinearity between regressors, the model shifts from its initial structure.

The regression models thus created have a predictive capacity on the dependent variable, in terms of R^2 , which is equal to at least 0.3543 and an F-value, always significant at the .000 level.

The regressors present in Estimate 1 (Table IX), usually used on models that determine the compensation available in literature, belong to the outsider profile (meeting activity and length of service), to the characteristics of the company's board (CEO duality, CEO compensation and Blau's index) and the company (industrial sector, ROE and total asset).

⁷³ For details on the results of the correlation analysis please go to the table in the Appendix.

Table IX – Estimate 1.

Regressors	Coef.	Std. Err.	t-value
Ceo Duality	-.2164702**	.1247967	-1.73
Ceo Compensation	.3027531***	.0877153	3.45
Blau's Index	.636403**	.3180522	2.00
Length of Service	.0488927**	.0152823	3.20
Meeting Activity	.5764335**	.2419820	2.38
ROE (Ln)	.1490911**	.0739777	2.02
Total Asset (Ln)	.0471207**	.0247019	1.91
Hitech Sector	.0471207	.1915784	1.55
Banking Sector	.2977909**	.1873625	2.60
Intercept	.4871749	.8002088	0.84
No. Obs.			233
R - squared			0.3543
F - value			11.48***

Note: The symbols *, ** and *** represent significance levels of 10 percent, 5 percent and 1 percent respectively.

The results of the analysis confirm the contribution of each of these in explaining the variability of compensations: all the regressors are positive and statistically significant.

The only exception is represented by the variable which is related to the hi-tech sector (Idum1) which, not being statistically significant, highlights an analogy between the compensation of the outsiders nominated in hi-tech companies compared to those nominated in pharmaceutical ones and, indirectly, a substantial difference compared to the compensation of those outsiders called in by the bank boards.

The regression model so created appears to be in line with the theoretical considerations and the preceding studies (Hempel & Fay, 1994; Vafeas, 2000; Linn & Park, 2005.) It also shows how the variability of compensations is strongly linked to the meeting activity of the outsider (a unitary increment of such a variable generates an increase in compensations equal to 57%) and, even if to a lesser degree, to its length of service (such a unitary increment created an increase in compensations of 4%).

Moreover, the compensations of the outsiders increase in proportion both to the diversity of the board and in proportion to the annual compensation that the company CEO receives. This confirms that, with reference to this last result, it is well founded to use the equity theory in the analysis.

Instead, when there is CEO duality (if the CEO of the company is also its Chairman, the compensation of the outsiders is reduced by 21%) the compensation decreases, which shows how the greater power attributed to the CEO in these situations influences the compensation level of the outsiders but in a negative way, the opposite of what was hypothesized in the initial part of this study.

Similarly as with previous studies, the variability of the outsiders' compensation is also explained by the control variables, such as profitability (the 1% increase of the ROE generates an increment in the compensation equal to 0.149%) and the size of the company (the increment of 1% of total assets generates an increase in compensations equal to 0.471%). The introduction of the popularity index into the regression model confirms the hypotheses formulated in this study (Table X).

Table X – Estimate 2.

Regressors	Coef.	Std. Err.	t-value
Ceo Duality	-.1975872	.1228135	-1.61
Ceo Compensation	.3023684***	.0858402	3.52
Blau's Index	.6132080**	.3040425	2.02
Length of Service	.0492308***	.0145197	3.39
Meeting Activity	.5604971**	.2373108	2.36
ROE (Ln)	.1420856**	.0723311	1.96
Total Asset (Ln)	.0454576**	.0245566	1.85
Hitech Sector	.3019316	.1892113	1.60
Banking Sector	.4901055**	.1832426	2.67
Popularity (Ln)	.0700583**	.0303004	2.31
Intercept	.5271501	.7872564	0.67
No. Obs.			233
R - squared			0.3702
F - value			11.11***

Note: The symbols *, ** and *** represent significance levels of 10 percent, 5 percent and 1 percent respectively.

The popularity of the outsider helps explain the variability in the compensations but only in the banking sector; the partial coefficient is positive and statistically significant. This result confirms the dependence of the compensation levels on certain aspects of the human capital of the outsider and shows how banks and financial companies recognize, in economic terms, the greater contribution that a “famous” outsider can offer to the running of the board of directors when all other parameters are constant.

In the same way, the involvement in the evaluation process of the board by external advisors, aimed at guaranteeing the impartial judgement on the efficiency of the board of directors, produces an increase in the compensation level (Table XI).

Table XI – Estimate 3.

Regressors	Coef.	Std. Err.	t-value
Ceo Compensation	.2590531**	.0875258	2.96
Blau's Index	.5613371**	.2563541	2.19
Length of Service	.0516508***	.0104951	4.92
Meeting Activity	.5643328**	.1885444	2.99
Total Asset (Ln)	.0500271**	.0250641	2.00
Banking Sector	.2323220**	.1029580	2.26
Popularity (Ln)	.0764947**	.0296483	2.58
External Board Evaluation	.2052003**	.1041752	1.97
Intercept	1.158937**	.6576523	1.76
No. Obs.			233
R - squared			0.3623
F (significance)			15.91***

Note: The symbols *, ** and *** represent significance levels of 10 percent, 5 percent and 1 percent respectively.

Such a result confirms the relation between compensations of the outsider and the decisional power of the company advisor who, practically a stranger to the board members and with fewer psychological pressures, can define, with proper reasoning, a compensation to outsiders which is relatively higher compared to that of other board members without creating particular internal conflicts in the company, modifying the organizational climate among the members of the board or, even, start a mechanism

which overall increases the compensation handed out to the other managers of the company according to what is expected from the equity theory.

The results of the analysis substantiate that even the absence of a different economic deal of the outsiders in relation to their role and responsibilities within the board, motivates certain actions which are in conformity with the correct governance practices. In this area, the outsiders who belong to the auditing committee of the company receive a compensation which is 30% less compared to that of other members (Table XII).

Table XII – Estimate 4.

Regressors	Coef.	Std. Err.	t-value
Ceo Duality	-.2171876	.1592062	-1.36
Ceo Compensation	.3067116***	.0922042	3.33
Blau's Index	.6892725**	.291124	2.37
Length of Service	.0419940***	.0105036	4.00
Meeting Activity	.9279123***	.2166179	4.28
ROE (Ln)	.1247776**	.0709273	1.76
Total Asset (Ln)	.0441892**	.0248309	1.78
Hitech Sector	.3070283	.1878545	1.63
Banking Sector	.4974622**	.1748650	2.84
Popularity (Ln)	.0588582**	.0291965	2.02
Audit Member	-.3096162**	.0965609	-3.21
Intercept	.4985779	.7713987	0.65
No. Obs.			233
R - squared			0.3982
F - value			13.29***

Note: The symbols *,** and *** represent significance levels of 10 percent, 5 percent and 1 percent respectively.

The result can be understood by bearing in mind the particular control role of the auditing committee in the present governance models, and that it be made up of members who are not only qualitatively competent, but also motivated to take on such a role irrespective of the economic reward. What could lead an outsider to take on the auditor role could be, for example, the opportunity to learn how other companies operate and the prestige derived when identifying with other impressive companies (Mace, 1971), or the intention of being recognised as an expert in the analysis and control of broad, organization-wide issues (Fama and Jensen, 1983). Instead, if one is to consider the role of the Chairman of the board or in a committee that is not an auditing one, the result changes (Table XIII).

Table XIII – Estimate 5.

Regressors	Coef.	Std.Err.	t-value
Ceo Compensation	.269082**	.0838398	3.21
Blau's Index	.478999**	.2504747	1.91
Length of Service	.0391109***	.0103157	3.79
Meeting Activity	.6876278**	.215692	3.19
Roe (Ln)	.0919559	.0660166	1.39
Total Asset (Ln)	.0486547**	.0239823	2.03
Banking Sector	.2831016**	.1006418	2.81
Chairmanship	.3035768***	.0808712	3.75
Popularity (Ln)	.050392**	.0286548	1.76
Audit Member	-.2769147**	.0946316	-2.93
Intercept	1.081382**	.6296779	1.72
No. Obs.			233
R - squared			0.4215
F - value			16.17***

Note: The symbols *, ** and *** represent significance levels of 10 percent, 5 percent and 1 percent respectively.

Compared to the members on the auditing committee, the outsider who covers the position of Chairman of the board or of one of the other committees, receives a higher compensation (roughly 30%) compared to the other members, based on greater responsibility and the coordinating role that the outsider takes on within the board or on the same committee. In this last model, the variability of the compensations, explained in terms of company profitability, does not seem to be significant and is therefore “captured” by other variables.

9. Conclusions

In this paper, after analyzing the CG origins, its different theories (*agency, stewardship, resource dependence, stakeholder, institutional and managerial hegemony theories*) which assign a different role to the board of directors, and their relative empirical studies, we examined the worldwide diffusion of the codes of best practices on CG, following the “OECD Principles of Corporate Governance” in 1999. Given the importance of the CG issues for banking organizations, we also considered supervisory guidance of the Basel Committee on Banking Supervision.

Then, we investigated in particular the UK CG system. Beginning from the Cadbury Report (1992), we analyzed the evolution of the UK CG codes with time and reviewed some of main empirical studies on the changes between the pre- and post-Cadbury periods, and we also compared the UK system with the US and Italian ones.

After that, we highlighted the USA outsiders origins and their progressive worldwide diffusion, making clear differences existing between outsider and insider systems. In addition, we analyzed some contrasting empirical studies about the relationship between boards and corporate performance, in particular between outsiders and corporate performance.

About our empirical research, this study has analysed the compensation determinants of 233 outsiders belonging to 40 English public listed companies present on the London Stock Exchange Market. This has been done by using a socio-economic theoretical approach.

In 2005, the average monetary compensation received by the outsiders of financial and industrial boards of the sample was of 75,000 GBP, with a variation of 64,000 GBP.

The compensation variance can be explained in terms of the outsider's traits: the role, the level of responsibility and the degree of participation in the company decision-making processes. It seems that the human capital of the outsider is also important, namely the personal characteristics the outsider has which are linked to the person's popularity on the market. Other factors which influence the variability of the compensation are the size, the diversity of the board and the characteristics of its

evaluation process, as well as the compensation given to the company CEO, and other attributes of the company itself, such as size, profit and industrial sector.

The main results of this study draw attention to the multi-disciplinary approach, based on the theory of human capital and that of equity, and can help explain the variability of outsider compensation by identifying a number of important factors.

The analysis in fact confirms the initial theory of this study. This is to say that the outsider's profile and certain mechanisms of corporate governance, as well as the company's characteristics allows one to expand on the knowledge of remuneration policies and on the procedures used by public listed companies in the different economic sectors.

This study has shown how the corporate governance mechanisms and the remuneration policy widespread in the bank and financial sectors present certain peculiarities compared to the hi-tech and pharmaceutical sectors.

The bank and financial sectors have the largest total assets compared to companies of other sectors and its board is also the largest, with a large number of independent outsiders. Moreover, these show the greatest degree of diversity and a greater number of expert outsiders, at the expense of the specialists. The banks, moreover, hand out larger compensations to outsiders compared to other sectors here examined. This can be justified if one takes into account the greater responsibility attributed to bank boards by the vigilance legislation of the sector.

The results of the analysis confirm that the factors that establish compensation are not only the role and responsibility of the board director, but also the contribution which the outsider brings to the company in terms of meeting activities, length of service and human capital.

The public listed companies recognize, in economic terms, the diversity of the roles (thus the responsibility and coordination of the actions) of the outsider who is nominated Chairman of the board or in those committees within the company. The auditing committee is the exception. Here, the companies give the members of its committee a lower compensation compared to others. This is done so as to recruit only those who are truly motivated by professional and reputation interests, to carry out the important assignment within the company. The highest compensation is given to the outsiders in relation to the person's meeting activity. This confirms the now widespread practice on the market to adopt the fee mechanism as the incentive for the outsider to take part at the board/committee meetings.

The analysis also confirms the variation in compensation associated to the length of service of the outsider in the company. This can be justified if one considers the increased experience and specific knowledge brought to the company by the director with time (Kosnik, 1990).

Compared to the results of Gray & Benson (2003) for the executives, this study confirms the company practice of recognizing a larger compensation to the outsider with high human capital, as this leads to greater professionalism and efficiency on the boards (Fama, 1980; Fama & Jensen, 1983). On the other hand, companies do not grant larger compensation in accordance with the level of experience of the outsider, as a further component of human capital in this analysis. This result is partly justified if one looks at the general experience level of the outsider (age-wise), which is essentially homogeneous in the different sectors.

Next to the relevance of the size of the board, highlighted in previous studies, this analysis confirms the influence both of board diversity and that of the advisor's role in the external evaluation of the outsider's compensation. The importance of the diversity can be justified if one acknowledges the greater efficiency in the management of the group arising from the numerous "points of view" and experiences within it. Instead, the largest compensation of the outsider in those companies that resort to the professional support of the advisor in the evaluation process of the board, confirms the company's practice of improving the quality of the governance processes by resorting to subjects who are external to the board and who, with fewer psychological conditionings, can define more efficient compensations and, if need be, foresee greater compensations for the outsiders without creating internal conflicts within the company as a result of this decision (Brown, 1993) or a means of overall increasing the salary within the company in view of the equity theory. Such a consideration seems further justified if one also considers the effect of the compensation of the CEO on the outsider's compensation in the same company, as confirmed by the equity theory used in this study.

As is the case with previous studies (Brenner & Schwalbach, 2001), the results confirm the unique effect of the size of the company on the compensation level of the outsiders, while the profitability of the company is not always relevant to the regression analysis.

The results show the attention given by English companies not only to the simple compliance to regulatory standards, but also promoting a “central” role of the board in the governance processes by defining the remuneration policies which are “sensitive” to the quality and to the correct functioning of the board.

Finally, it is believed that further analyses could further enlarge the set of regressors to look at other attributes of the outsiders, of the board and of the governance structure. Alternatively, by also diversifying the industrial sectors within the sample, the following analyses could increase the number of years used in the observation, referring it to the Country. This would show the possible developments in the remuneration policies of public listed companies on the financial market, or be able to compare Countries with different governance models so as to understand the possible differences in the remuneration mechanisms of the independent directors.

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Appendix

Correlation between some variables.

Variables	Lcash05 ¹	Lpop_uk ²	Ceo05 ³
Lcash05 ¹	1.0000		
Lpop_uk ²	0.1647* 0.0118	1.0000	
Ceo05 ³	0.4115* 0.0000	0.0547 0.4056	1.0000
Ltan ⁴	0.4178* 0.000	0.0551 0.4026	0.6772* 0.000
Idum1 ⁵	-0.3636* 0.0000	-0.0511 0.4377	-0.5571* 0.000
Idum2 ⁶	0.3559 0.0000	0.0268 0.6837	0.3707* 0.0000
Board_d1 ⁷	0.4681* 0.0000	0.1664* 0.0110	-0.0340 0.6052
Board_d2 ⁸	-0.1966* 0.0026	-0.0607 0.0000	0.1113* 0.0901
Board_d3 ⁹	-0.0308 0.6396	0.0573 0.3836	-0.1286* 0.0499
Expdum1 ¹⁰	0.0492 0.4546	-0.0435 0.5083	-0.1390* 0.0339
Expdum2 ¹¹	-0.0342 0.6032	-0.0375 0.5688	0.0557 0.3972
Expdum3 ¹²	-0.0342 0.6032	-0.0375 0.5688	0.0557 0.3972
Length ¹³	0.2731 0.000	-0.0108 0.8695	-0.0272 0.6798
Meet_act ¹⁴	0.0389 0.5542	0.0074 0.9106	-0.2563* 0.0001
Shareopt ¹⁵	0.1154* 0.0789	0.0630 0.3384	0.1518* 0.0204

NOTES:

- 1= Logarithmic of 2005 total cash outsider's compensation
 - 2= Logarithmic of the outsider's popularity
 - 3= Logarithmic of the CEO 2005 total compensation
 - 4= Logarithmic of the Total Asset of the firm
 - 5= Firm of Hi-tech industrial-sector
 - 6= Firm of the banking industrial-sector
 - 7= Dummy of the chairman of the boards
 - 8= Dummy of the independent outsider director
 - 9= Dummy of the independent outsider director
 - 10= Dummy of the specialist's profile
 - 11= Dummy of the expert's profile
 - 12= Dummy of the generalist's profile
 - 13= Length of service of the outsider in the firm
 - 14= Meeting Activity of the outsider
 - 15= Presence of shares/options in the structure of the outsider compensation
- *= The symbol represents the significance level at least at 10 percent.