

RESPONSE OF DUNCAN ALEXANDER

23 August 2002

Derek Higgs Esq.,  
Review of Non-Executive Directors,  
Department of Trade and Industry,  
Room 2142,  
1 Victoria Street,  
London,  
SW1H 0ET

Dear Mr Higgs,

Independent Review of Non-Executive Directors

I have read your consultation paper: *Review of the role and effectiveness of non-executive directors* and now make my comments on it. My perspective comes from being a *working* investor creating and running small businesses and being a *passive* investor by investing in publicly quoted companies around the world. I would like to confirm that I have made contributions to the DTI Company Law Review, the Auditing Practices Board on Aggressive Earnings Management, the Sandlers' Review Team on medium & long term retail savings and most recently to the Treasury Committees' inquiry into the financial regulation of Public Limited Companies.

In summary, if it is found necessary to legally define a **non-executive director**, it should be described as a **director who does not hold any executive or management position in the company**. I have my doubts that it is necessary to examine the fine detail of this role until the basic principles behind the modernisation of Company Law are laid down by the government. To my mind, it would be best to have an outline of the rights and responsibilities of the various stakeholders involved in business before we give a detailed description of the various elements.

My observations to your Background comments in your paper (Paragraph [Para] 8 to 15) are:

Para 11. A White Paper on Modernising Company Law has now been produced and the role of non-executive directors does not appear to be listed under Director duties (Page 26)  
- Remember to think small, non-executive directors will not always be needed in companies  
- allow the owners of a firm to decide what is in their best interests - the State does not have divine or superior knowledge in the areas of business judgement - remember the recent *Dome* fiasco!

Para 12. There is a clear need for Institutional investors to split their dealing and proprietorial roles.

Para 13. In the case of larger companies, it needs to be recognised that faulty judge created law has separated owners from control of their venture in trade. Hopefully, the modernisation of Company Law will correct this and other errors.

Para 14. The Cadbury Committee said (4.4 to 4.6) "... *Non-executive directors have two particularly important contributions... The first is in reviewing the performance of the board and of the executive...* Comment: **Wrong** - This should be done by the owners through their representative(s) on the board reporting ideally through an owners audit committee rather than by a formal meeting of members . . . *The second is in taking the lead where potential conflicts of interest arise . . .*" Comment: **Wrong** - Potential conflicts of interest problems such as take-overs, boardroom succession and directors pay should be done by the owners' audit committee.

The Hampel Review observed "(3.8) *Non-executive directors are normally appointed to the board primarily for their contribution to the development of the company's strategy...*" Comment: Clearly **wrong** - That is the job of the investors - it's their venture in trade. Non-execs should be there to broaden the focus of their over focused executive colleagues and recognise the interests of other stakeholder groups. It is essential to have the owners interest represented on the board to provide a sounding board and to report back to the other owners.

Remember the John McFall (chairman of the Treasury select committee) comment in *The Business* 18/8/02 when he gave the following answer to the question: What lessons can a company learn from Enron? His answer: "*Non-executives should be the eyes and ears of shareholders, not chief executives. One area where this cosiness is all too obvious is the supervision of boardroom pay by remuneration committees, largely stuffed with sympathetic non -executives. The regulatory process is in need of urgent change - dependence on 23 separate regulatory bodies funded by the industry is absurd A single independent body should be established and confidence in the independence of the auditor is absolutely central. Independence is also clearly open to question when auditors perform a significant consultancy role, especially when the audit contract is a loss leader to the more lucrative consultancy business. Audit committees of listed companies should be required to publish details of audit and non-audit contracts, supplying shareholders with detailed justifications. One of the most important tasks is to establish core international accounting standards by 2005 and tackle accounting for share options - an obsession with inflated share prices has resulted in rich chief executives retiring to a lifetime of luxury, leaving bankrupt companies in their wake. This practice is more common in the US, but by no means are we immune.*"

My comments to your issues for consideration:

**A. Role of non-executives.**

The role of the board is to take instructions from the owners and to carry out their wishes for their venture in trade. The Chairman of the board in consultation with the owners will then be responsible for co-ordinating the appointment of executive directors covering specific areas of the operation such as sales, purchasing and finance. Non-executive directors may be appointed to represent other stakeholders. It is essential, especially with the emergence of determined boardroom fraud and the arrival of mechanistic management techniques, that the owners are represented on the board and that they have a fiduciary responsibility to other shareholders. With large quoted companies with fragmented ownership, an owners audit committee should come between the shareholders and the board of directors. It should

represent the *spirit* and *soul* of the company and provide the *collective wisdom* of the owners.

We need to recognise that a fundamental error has been made by the Judges in their fostering the notion that ownership and control of business activities should be separated. The existence of owner/managed companies blows a hole in that "*legal fantasy*" and seriously damages the credibility of our judicial operatives.

**B. Attracting and appointing non-executives.**

Once the reformed Company Law Bill becomes an Act, we should have a much improved idea of the rights and responsibilities of directors and a better understanding of their fiduciary duties to the owners of the company. There needs to be a recognition by non-executives of their poor reputation in the eyes of some investors. There needs to be a determination to reverse this. One way this could be demonstrated in publicly quoted companies, is for the non-executive directors to have say 2% of their own personal wealth in the shares of the firm. This personal financial commitment would in my view make the people involved more aware of the need to counter the over focused shortermism demonstrated by some executive directors, help promote prudent risk taking and enable non-executives to experience the pain/pleasure of investors.

From this background, attracting and appointing non-executives could come from conventional advertising, informal inquiries amongst investors and trade associations such as the IoD with the owners overseeing the selection process. Professional negligence insurance should be compulsory for all directors of publicly quoted companies.

**C. Structures and accountability of non-executives.**

Please see the answers to questions A and the first para of B. An obsession with systems and processes in corporate governance are inappropriate at this stage until the basic principles of business are re-established in the European domain.

I would welcome moves to criminalise corporate misdemeanours in the quoted company sector. It should be realised that the **Sarbanes-Oxley Act 2002 [SOA]** in the USA details a -240mass of corporate governance rules and regulations which threatens to sweep through British boardrooms and submerge the UK governments own rather leisurely initiatives for corporate reform. Most investors will support the SOA requirement that:

- (1) CEO/CFO must personally certify both the accuracy and completeness of their reports - here in the UK that will require the reversal of the House of Lords *Caparo* judgement and also the reversal of the legal concept that auditors are not there to discover fraud or misstatement.
- (2) Insider trading reports - requiring directors, executive officers and greater-than-10% beneficial owners to file reports of transactions in the public companies securities by the second day after the execution of the transaction.
- (3) Increased whistle-blower protection.

**D. Relationships with shareholders and others.**

Your Question: Do existing relationships with shareholders or others need to be strengthened? My Answer: Yes.

One of the fundamental tasks of the Company Law Bill will be the resolution of the questions:

- (1) Does an investor in a publicly quoted company have any role in determining the future destiny of their company or are they just the owner of a tradeable lottery ticket?

I believe that members of a company should consider themselves part of a venture in trade organised on a working, modified - in the sense that the more shares you have the greater your voting power - democracy basis. Our laws should recognise this and encourage owners to evaluate the risks involved in that venture and provide workable structures for them to develop their firm.

- (2) Should an individual investor have the right to base *governmental* and *dealing* decisions on the basis of the audited accounts of publicly quoted companies?

I believe they should and that reliance should be extended to both Crown and private creditors.

#### E. Support.

I believe that non-executive directors should be the "*eyes and ears*" of the owners on the Board of Directors. An open, full sunshine approach to all company information should be adopted with only a few individually discussed items excluded.

#### F. Small listed companies.

I do not believe the rules should be significantly different for smaller listed companies.

#### G. International context.

Your question: What can we learn from international experience? My answer: Quite a lot.

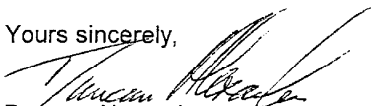
We need to recognise that over the last few years here in the UK that:

- (1) Power over the destiny of a company has shifted from shareholders to the Board of Directors responsible for day-to-day activities.
- (2) Auditor responsibility has shifted from protecting the interests of the owners to one of supporting the day-to-day managers.

In my opinion both these developments need to now be reversed by the new Company Law Act.

We know that the USA is moving aggressively on investor protection, let's hope that Europe does not drag its feet on this important matter. I would be glad to answer any questions you may have and have no objection to this letter being put into the public domain.

Yours sincerely,

  
Duncan Alexander