

REVIEW OF NON-EXECUTIVE DIRECTORS

*Submission from AXA Investment Managers
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1. INTRODUCTION

AXA Investment Managers believes that this Review represents an important opportunity to restate the relevance and importance of high standards of corporate governance in the post ‘bull market’ environment and draw lessons from the fallout being experienced as we return to more normal market conditions.

In general, we believe that standards of UK corporate governance are high and we would not wish to see companies’ wealth creation curbed by unduly burdensome new structures.

We have contributed to the Review submission from the Association of British Insurers and are broadly in line with the detailed views expressed therein.

We would therefore like to make a more general contribution to the debate. We have a concern that there is a lack of clarity about the role of non-executive directors. Indeed, typically non-executives are expected to fulfil a variety of roles. Though it is entirely possible for these to be combined, there is the risk of a lack of focus on one or more of the elements.

Hampel comments ‘non-executive directors are normally appointed to the board primarily for their contribution to the development of the company’s strategy. This is clearly right.’

We are not entirely comfortable with the singularity of focus implied by this statement. In particular, we believe that an essential part of the role of non-executive directors is to help manage the issues that inevitably arise as a result of the separation between the ownership and control of quoted companies; issues that are classic to any principal / agent relationship.

2. ROLES OF NON-EXECUTIVE DIRECTORS

Non-executive directors have accumulated a number of roles. These include:

- strategic advice to executive management;
- oversight of delivery of company strategy;
- determining executive remuneration;
- oversight of internal & external audit process and delivery;
- assisting with selection and removal of executive directors; &
- enhancing company profile and broadening networks.

3. PRINCIPAL / AGENT PROBLEM

The owners of companies appoint agents – executive management – to manage their assets on a day-to-day basis. As is the case with all agency relationships, it is important to ensure that the objectives of principals (shareholders) and agents (management) are aligned and, in particular, that the latter acts clearly in the interests of the former.

There are many reasons why this might not be the case and, indeed, until the advent in the 1980s of stock options and other incentive schemes geared to corporate performance, there was little reason to believe it would be. Executive management may well have focused on maximising

sales or the number of employees or some other variable that signified stature or importance. There was certainly little incentive to take tough decisions until the market for corporate control was more fully developed in the 1980s.

Although they may be different in nature from 20 years ago, these potential conflicts of interest between management and shareholders remain. Non-executive directors, through their enforcement of good corporate governance, are the principal bulwarks against them.

Examples of agency problem

We see four main kinds of agency problem, which need to be addressed:

1. Strategic misalignment – the strategy being followed is not in the interests of shareholders. There are a number ways in which this might come about. Ironically, some relate directly to the potential moral hazard of executive share options.

Executive management, and particularly the CEO, conscious of the relatively short ‘life span’ they enjoy can become excessively focused on the performance of the share price in the short term. This can lead to a failure to plan sufficiently for the long term. The maxim ‘in the long term we are all dead’ can be taken to extremes.

There is also a danger that executive management becomes too much of a ‘risk preferer’ – the value of stock options is geared to the volatility of the share price. Re-testing of performance criteria even gives management further bites at the share option cherry.

Our preference is for the corporate sector (in any country) to recycle excess free cash flow so that the market can reallocate it to those areas of the economy where it can be best deployed. We would then expect firms that need additional resources for a new strategy to come back to the market. Management often prefers to retain free cash in order to take advantage of acquisition or expansion opportunities as they arise. Such growth may satisfy executive ambitions but be contrary to shareholder interests. Retaining cash for these purposes also implies a lack of confidence in the willingness of the market to fund opportunities when they arise.

These are just three simple examples, but more generally it is clear that a strategic direction that is in the interest of executive management may not always be aligned with the interests long term shareholders. The potential conflicts in this area may be addressed within non-executives’ broad strategic role but this will not necessarily be the case.

2. Executive compensation – there is a clear and understandable risk that executive management will seek to reward and incentivise itself more aggressively than justified by market comparables or in other ways that conflict with the interests of shareholders.

3. Reporting, full disclosure & control – at the basic level of the principal / agent relationship, it is clear that the principal (shareholder) would demand complete transparency and the ability to understand fully how the business he owned was performing. The principal (shareholder) would also insist that robust control systems were in place – it is his money that is at risk.

There is no *a priori* reason why there should be any conflict in this area between the interests of management and shareholders, but the evidence suggests that even strong, well-intentioned management is not always as ‘open’ as it might be. Most importantly, as recent events have demonstrated, when things begin to go wrong there are often considerable incentives for management to engage in ‘spin’ and, in the worst cases, descend the slippery slope.

4. *Removal of Chief Executive* – from time to time, though hopefully not too often, the principal may wish to remove the agent because he is / they are not performing very well. In this situation it is clear that interests are not aligned.

In each of these areas of potential conflict, there is a clear role for non-executive directors to ensure that the interests of shareholders are fully protected.

4. RANGE OF BACKGROUNDS

It is far from clear that non-executive directors of UK listed companies are selected on the basis of their ability to represent shareholders' interests, by addressing this agency problem.

At present, non-executives have a relatively wide range of backgrounds. These include:

- current and former executive directors of other listed companies;
- former executives of businesses that have been absorbed into the company;
- former politicians and senior civil servants;
- high profile figures from foreign markets important to the company;
- those with a degree of profile in domestic life;
- experts in fields relevant to the company's areas of business; &
- employee representatives.

There is a likelihood that non-executive directors such as these focus more on supporting the management team and less on their role as managers of the principal / agent problem.

Furthermore, whilst diversity is to be welcomed, these backgrounds often leave non-executives ill-equipped to fulfil some of the roles expected of them. On smaller boards, it is unusual to find more than one non-executive with in-depth expertise in any particular role.

5. IDEAS FOR CONSIDERATION

We believe that it would be helpful for the Review to make a clear statement of the role of non-executives and their responsibilities to shareholders. This might be underpinned by formal codification – whether in statute or listing rules – or even a report to shareholders.

This suggestion does not undervalue the contribution made at present by non-executives, particularly in small companies. However, we are aware of examples in the recent market cycle where non-executives were unaware of key financing data that had a significant impact on valuation. We believe that such oversights arise out of a confusion of roles.

In addition, the Review might consider whether formal training leading to a threshold competence test or a new qualification would ensure that all non-executives have a good knowledge of the issues most relevant to their monitoring role: accounting, debt & equity finance, and remuneration. Existing non-executives could be 'grandfathered' into either.

A further bulwark to investor confidence in non-executives calling management to account might come from the creation of a new post for professional independent non-executive directors. These might be elected separately, bringing to the board a high level of expertise in key aspects of non-executives' monitoring role. Commercial organisations might like to offer candidates, similar to Law Debenture trustees for pension funds. Consideration could also be given to the development of a professional body, actively supported by institutional investors, to focus on understanding and defining the requirements of corporate governance and then train full-time

professionals to serve on company boards as shareholder representatives. Career development for these independent non-executives could depend upon their professional body or the firm for whom they worked, rather than the companies on whose boards they sat.

We have great confidence in the integrity and professionalism with which non-executives of UK companies approach their duties. But in an age of increased business complexity, many of the aspects of the non-executive role require a degree of functional specialisation that could not be expected of someone with a full-time role in an unrelated field.

There are undoubted merits in the application of informed scepticism to internal and external advice but we believe that levels of board expertise could usefully be supplemented both with increased training and the appointment of professional non-executive directors.

These suggestions are intended to stimulate debate as to how non-executives fulfil their role within a unitary board. They are not presented as complete or ideal solutions, free from new tensions. Our aim is simply to bring the focus back to the position of non-executives in principal / agent relationship between shareholders and management.

6. OTHER ISSUES

Liability. We have some concerns about a climate in which individuals are held financially liable for corporate decisions made by competent directors in good faith on the basis of information then available. If liability for non-executives is to continue, this might properly be limited to the amount of their remuneration for the relevant period.

Remuneration. We believe that higher levels of remuneration are compatible with increased professionalisation of non-executives and demands for a greater time commitment. We favour high levels of share ownership amongst all directors and regard partial remuneration through grants of shares as appropriate for non-executives. We are opposed to share options or other incentive schemes for non-executive directors as these can compromise their role. If non-executives hold shares they will benefit from any appreciation in shareholder value.

Independence. We do not believe that it is necessarily desirable for all non-executives to be independent under current widely used definitions. Representatives of large shareholders, employee representatives, and those with other links can make a useful contribution.

Senior non-executive director. We have an on-going programme of meetings with senior non-executive directors. We have selected companies with perceived corporate governance weaknesses. We have often been the first institutional shareholders to approach the director concerned. Some of the directors we have seen would not be considered independent, although we have found no correlation between independence and competence.

The style of the directors we have met has varied considerably but we have left the meetings confident of their integrity and willingness to pursue the issues we have raised. In some cases we have been less confident of their ability to instigate change. Thus far, price sensitive information has not been raised, although the meetings have generally enhanced our understanding of how far companies are addressing the challenges they face.

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