

*Review of the role and effectiveness of  
non-executive directors*

*Response from*

*British American Tobacco p.l.c.*

*to the*

Higgs Consultation Paper

## A: Role

**What role should non-executive directors perform, and how does this compare to the present position?**

**Possible issues for comment:**

1. **What is the role of the board? What is the role of the Chairman and how does it relate to the non-executive directors?**
  - a. The role of the board can be summarised as being:
    - i. to set the strategy /direction of the company
    - ii. to monitor and hold accountable management for executing it.
    - iii. to establish appropriate systems of corporate governance
    - iv. to allocate resources to the various strands of a company's activities.
  - b. The role of the Chairman will principally depend whether the holder is executive or non-executive. If executive, which post-Hampel is less common than was the case, he is the undoubted leader of the board and of the company; ultimately he is answerable for the success or failure of the strategy set by the board.
  - c. If non-executive, his primary role is to manage the interface between the executive and non-executive members and to be sounding board for the chief executive. In extreme cases, he will be the catalyst for changing the executive and/or the company's strategy.
  - d. A non-executive chairman should be regarded as independent, and therefore not be barred from sitting on the audit and remuneration committees. Otherwise there is a danger of marginalising the chairman.
2. **What should be the key roles of non-executive directors on the board and what should be the balance between the different components? Within a board, should all non-executive directors be expected to fulfil each of the different roles?**
  - a. The key role of NEDs. is to bring a 'real world' focus, or at the very least a different, 'external world' focus, to consideration of strategy and its implementation.
  - b. As part of that role, to act as devil's advocate, particularly where one member of the executive is so forceful as to make it likely that other executive directors will always concur with him.
  - c. There is no ideal formula, as it will differ from company to company. Although there should usually be more NEDs than execs, if enough candidates of the right calibre can be found, there needs to be a sensible balance. An almost completely non-executive board, as is often found in the USA, can become too remote and too reliant on the CEO for information.
  - d. It is unrealistic to expect all NEDs to fulfil all roles; they should have been selected for their diversity of background and experience, which will equip them better for some roles than for others. They should not be serving for the sake of personal development, though that will sometimes be a beneficial by-product.

e. We support the current position where all directors share responsibility for the actions of the Board, though we also support legal precedent as to what any particular director might reasonably be expected to know (ie, a form of mitigation which might make one director less culpable than others).

f. We also believe that the Board as a whole, rather than the NEDs alone, are guardians of the company's ethical behaviour.

3. **How does this compare to the present position?**

a. In principle it does not differ, though in practice it can as each company will have taken its own approach to the selection of NEDs and to making use of their abilities.

4. **How independent do non-executive directors need to be for the different roles?**

a. This depends on the definition of 'independence', which is usually taken to mean independence from the company and also from its executive, but can mean length of service on the same board (the longer the period, the less the independence).

b. In general, it is better for a NED not to have been an executive director of the same company, or to have any financial involvement with it except fees. We do not consider, however, that the presence on Board Committees of representatives of major shareholders (who by some definitions are not independent) should be precluded and may arguably benefit shareholders generally.

c. A single definition of independence, rather than the growing number of sometimes conflicting ones, would be helpful as an indication of 'best practice' but it is ultimately for the company to determine, taking into account all relevant facts and circumstances. Independence is basically a state of mind rather than conformity with a definition.

5. **What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a role in protecting the interests of the company? What can be done to help non-executive directors to be effective in relation to these conflicts?**

a. There should not be conflicts of interest in the boardroom and company law already provides adequate guidance on what should happen if a conflict of interest does arise.

b. Conflict is within reason a good thing in the boardroom - a key element of a NED's role is to ask the questions that the executive has not thought of, or has but does not want to answer. But that is not the same as saying that the NEDs are always right and should therefore have some overriding powers.

6. **What time commitment is needed for the role of Chairman and for non-executive director roles, and how far does this vary between different companies? Are there any implications for the number of non-executive posts that one person can sensibly take on?**

a. The question presupposes that the chairman is non-executive. That may be the norm but it is not universal and an executive chairman needs to spend all, or substantially all (allowing for non-executive appointments) his time on company matters.

b. The time commitment of a non-executive chairman or other NED will depend to an extent on the demands on him that the company makes and the number of board committees on which he sits, but it is no longer enough just to read the papers on the morning of the meeting. The chairman should expect to be available to the chief executive almost at will and conversely should initiate contact regularly. Other NEDs need to keep abreast of the company's activities between meetings.

c. Commonsense dictates that there should be a limit but it will not be the same for all individuals and should not be prescribed by law or regulation. Control lies in the hands of the company proposing to appoint, which it should do only if satisfied on enquiry that the individual does not already have commitments that might affect his ability to carry out new duties.

7. **Should there be a special role for a "senior independent" non-executive director?**

a. There already is, under the Combined Code. Perhaps the question is really asking whether the Code is right to require such a person. There may be a need where the chairman is executive but less obviously where he is not, since by definition the chairman is then the senior non-executive director.

b. The way companies have made use of the role since the Combined Code was introduced might be a suitable area for research.

8. **Do you have comments on the proposed statutory statement of directors' duties, which does not seek to distinguish between the legal duties of executive and non-executive directors?**

a. We support the principle of the proposed codification of directors' duties.

b. It must in principle be right that, as now, all directors share responsibility for the actions of the board. However, in an increasingly litigious and complex society, it is unrealistic to maintain that NEDs, who are part-timers, are in a position to have the same influence on the way the company is run as are the executive. Nor are they paid commensurately for undertaking such risks.

c. One solution may be to relax the statutory and other restrictions on indemnifying and purchasing insurance for NEDs. There must otherwise be a risk that people of the calibre that the Combined Code and institutional investors demand will increasingly be unwilling to accept appointment because the prestige and rewards are overshadowed, even in a well-run company, by the potentially catastrophic liabilities that could ensue (as former Equitable directors may agree).

## B: Attracting and appointing non-executives

**What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?**

**Possible issues for comment:**

9. What are the key skills, knowledge and experience which are needed by non-executive directors to perform the role effectively, and how is this likely to change over the next, say, 10 years? Are some skills essential and, if so, what are they?

This will differ from company to company:

numeracy skills are increasingly important for members of Audit committees, particularly their chairmen;  
the ability and resolve to ask difficult questions of the executive without it being seen as a challenge to authority;  
someone with the experience of running a comparable company (in size, or geographic markets but probably not in products) would be useful but not essential.

10. What personal qualities and attributes are needed?

Integrity would be high on any list;  
independence of mind (however the word is defined as a test for classifying NEDs);  
reluctance to be deflected from following up an enquiry;  
experience of running similar organisations (or even disparate ones, if that brings relevant experience);  
'recognition' in financial and other key markets;  
an understanding of when not to intervene in executive issues.

11. What sort of mix of experience and attributes is desirable on a Board? Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.

This will vary from company to company, and within the same company, at different times. Knowledge that complements that of the executive directors, e.g. political, technological or geographic, will always be of value.

12. How easy is it to recruit non-executive directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?

a. It is not a problem for a large company and there are plenty of 'headhunters' to aid in the search.

b. Too many companies are interested only in appointing those who already have plc board experience; this rules out able people just below main board level and will be more of an issue as the 'executive' element of boards decreases.

c. The mechanisms are not very substantial in practice and present no bar to the appointment of anyone the board wishes to appoint. This is appropriate – shareholders

always have an early opportunity to remove a director by declining to re-elect at the next AGM.

13. What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?
- a. Is 'diversity' another way of expressing the desire for a 'politically correct' balance on boards? Any requirement for a 'politically correct' balance would be a major disservice to corporate governance. The constraint is the number of suitably qualified individuals of whatever age, gender, race or ethnic background.
  - b. There is no legal limitation on international representation on boards, though geographic distance may be a practical one that video-conferencing and conference telephone calls can only partially overcome.
  - c. Companies should be more willing to recruit NEDs from managers just below main board level in other companies.
  - d. The statutory requirement to show home addresses on Companies House registers may deter prospective overseas appointees (the scope for 'confidentiality orders' under recent legislation is very narrow and is unlikely to make a significant difference).
14. Are the rewards for non-executive directors appropriate, both in terms of levels of pay and the form that remuneration takes – e.g. cash/shares/share options? Are current pay levels a significant factor in whether good non-executive directors can be attracted?
- a. Given that NEDs are in law equally responsible, their rewards are probably inadequate in terms of the risks they increasingly face.
  - b. There are mixed views on whether shares/share options are a suitable form of reward for NEDs. One school of thought wants directors to take shares, in order to align interests and risks with those of shareholders; the contra thought is the exact opposite, that independence requires separation of economic interest. Hermes would like NEDs to be paid at least in part in shares, to be retained whilst on the board; NAPF also support but say that they should not take 'significant' holdings.
  - c. If payment is in shares, it should be for a pre-determined fixed number, rather than value. Intuitively, a value basis might suggest a motive for keeping the share price low.
  - d. It is too soon post Enron etc to be able to say whether prospective NEDs are turning down appointments because of low reward levels but the normal laws of supply and demand are likely to apply.
15. Do you have comments on the issue of risks or insurance provision for non-executive directors?
- See answer to 8 above. There should be greater scope for protecting NEDs whilst they continue to have the same liabilities as executive directors.

## C: Structures and accountability

**Do existing structures and procedures facilitate effective performance by non-executive directors?**

**Possible issues for comment:**

16. How is the Combined Code working in practice? In particular, how are the provisions on the balance between executive and non-executive directors and the role of independent non-executive directors working? Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?
  - a. The Combined Code has enhanced corporate governance, both in absolute terms, because listed companies have to consider and report on specific issues, and in raising awareness generally. It works well primarily because it is non-statutory and therefore allows divergence, subject to this being explained; it should remain a code, to allow for amendment as the scene changes.
  - b. The Code does not distinguish in terms of roles between independent and non-independent NEDs, except for the 'senior' independent. Nor should it: the joint and cohesive nature of a UK board would be diminished by the further categorising of sub-groups within it.
  - c. A definition of 'independence' is needed in order to avoid the current position of several definitions propounded by groups with special interests, but should not be mandatory.
17. Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors? Are board meeting procedures working effectively? Do you have comments on board size?
  - a. Broadly yes, but may be misleading to the public because, by definition, NEDs have to rely on the executive for most of their information. The greater the number of committees, the greater the number of NEDs required to serve on them.
18. Do you have comments on the composition and duties of Audit Committees? How effectively are Audit Committees working in practice? Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?
  - a. In principle the Audit Committee is a committee of, and is answerable to, the board. Unless this changes, it is difficult to see how any recommendation about auditors can go to shareholders other than from the board, albeit based on the committee's recommendations.
  - b. Things have moved on since the Higgs paper came out: new US legislation [Sarbanes-Oxley] imposes limitations on who can serve on audit committees and on auditors performing specific types of work for their audit clients. It is to be hoped that HMG will argue the case against US domestic legislation being extended to non-US companies

whose shares are traded in the US. In any event, HMG should avoid this sort of over-detailed prescription for UK companies.

19. **Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?**
  - a. There should be a clearer understanding of the role of the Remuneration Committee in setting remuneration policy and actual rewards for executive directors and, if the number of executive directors declines, other senior managers.
  - b. The presence on the Remuneration Committee of representatives of significant shareholders, who by many definitions are not independent, is arguably a benefit as they might be expected to want to control reward to a greater extent than NEDs who have no stake as shareholder.
  
20. **What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?**
  - a. The Board sets objectives to be achieved by it as a whole, though it is only the remuneration of executive directors (who are assessed collectively for bonus purposes) that is affected by success or failure to achieve these.
  - b. A formal review of business performance is essential, as is a separate formal review of board performance (including the NEDs).
  
21. **Could more be done to review performance? Should more information on board performance be reported to shareholders? Should companies provide more information on the performance of non-executive directors?**
  - a. This is unlikely to serve any practical purpose.
  - b. There seems little value in reporting on NEDs; if management is unhappy with their performance, it has remedies, such as not allowing the name to go forward for re-election.
  
22. **Are non-executive directors able successfully to challenge executive decisions or expose serious problems? Should it be made easier for them to do so and, if so, how?**
  - a. Easier to challenge in what forum? If NEDs cannot persuade colleagues, especially where they are in a majority (as will usually be the case in a listed company), their alternatives are to put up or resign. There should be no scope for allowing some external organisation or the press to second-guess a board decision that is yet to be implemented.
  - b. What does 'serious problems' imply? If there are illegalities the duty is clear. If strategies are not working out, that is an internal matter, to be resolved by changing management.

## D: Relationships with shareholders and others

**Do existing relationships with shareholders or others need to be strengthened?**

**Possible issues for comment:**

23. How well do relationships between non-executive directors and shareholders and stakeholders work, and could they be improved? For example, we would be interested to hear views on what the relationship might be between non-executive directors and institutional shareholders. How could this relationship be strengthened?
- To give institutional investors preferential rights of access to NEDs risks the unwitting/unauthorised disclosure of information in breach of the FSMA. It should be strongly discouraged, as NEDs are not and should not be seen as spokesmen for the company.
  - It is also reasonable to ask to what purpose such access would be put and whether this would be to the detriment of smaller shareholders.
  - It may be appropriate for the non-executive chairman (or the deputy chairman as 'senior independent NED' where the chairman is executive) to meet with senior representatives of institutional investors.
24. To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more that they could do, by promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows, or otherwise?
- It will depend on the chairman and NEDs in question. The diversity of companies makes it difficult to legislate for this.
25. What should be the relationship between non-executive and executive directors, and with senior management? What should their relationship be with the Chairman and the Chief Executive? What should their relationship be with key advisers to the company?
- The principal relationship should be with the chairman/CEO but access to other directors should be encouraged.
  - The chairman of the Audit Committee should have a direct relationship with the audit partner.
26. How can Company Secretaries support effective performance by non-executive directors?
- by ensuring that NEDs:
    - are aware of their duties as directors and are up-to-date with current developments in law and corporate governance;
    - have adequate opportunity to express their views, e.g. through board evaluation.

- b. by ensuring that sound systems of corporate governance are in place and reviewed regularly.
- c. By utilising their perceived role as the company's conscience; and using the semi-independence that arises from their professional obligations to introduce NEDs to support functions such as in-house counsel.

## E: Support

### How can non-executive directors best be supported to perform their role?

#### Possible issues for comment:

27. How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?

It is impracticable for part-time NEDs to handle the same amount of information that executive directors receive. They should, however, expect management to provide all that they need to make informed decisions and be entitled to ask for anything that they consider relevant.

28. What training and development opportunities are available? Could they be improved and, if so, how?

In normal circumstances, NEDs should not need training; they are frequently experienced executives from other companies. But the IoD among others run courses on director training if it is thought that a NED needs this – perhaps one from overseas who is unfamiliar with the UK approach to corporations or someone who comes from a non-corporate background, such as a politician or an academic. However, we do not need a formal qualification as 'Director'.

29. Can induction for non-executive directors be improved?

a. This is a matter for each company. 'Improved' is relative and most things can be – is there evidence that induction is not satisfactory or is it rather that not all companies bother? That reflects poorly on both the company and the individual accepting appointment without the promise of adequate induction within a short time.

b. In particular, all NEDs should meet the auditors, as well as other board members, before accepting appointment, to satisfy themselves that controls are in place.

30. Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?

Perhaps NEDs need to be asked this – the remedy is in any event in their own hands as they can ask the chairman.

## F: Smaller listed companies

In what ways is the position different for smaller listed companies?

Possible issues for comment:

31. To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?

The substantial differences between a FTSE company and a small plc need to be recognised.

## G: International context

What can we learn from international experience?

Possible issues for comment:

32. What lessons can be learnt from international experience, either in terms of structures or behaviours?

a. This question strays outside the scope of the enquiry, entering into territory covered by the DTI's review 'Modern Company Law for a Competitive Economy', and the recently published White Paper 'Modernising Company Law'.

b. The principal alternative to the UK structure is the German supervisory/management boards approach. That model is not generally thought by UK business to be relevant, because structures grow up around the local law and legal system.

c. Recent US legislation – the Sarbanes-Oxley Act – shows an unwelcome desire to impose domestic laws extra-territorially, which HMG ought to seek to resist. If the USA does it, others may follow.

d. The USA experience, where boards are often dominated by NEDs, is not a good example.

33. Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?

This is impossible to answer. Corporate governance or the lack of it may contribute, for good or bad, but so do many other factors and it would be simplistic to attempt to apportion the role of any of them in performance.

34. Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?

A recent comparative study for the EU into corporate governance codes concluded that notwithstanding formal structural differences [between unitary and two-tier boards], “the similarities in actual board practices are significant”. So a reasonable conclusion, at least in relation to the EU, is no; the only other comparable system is that of the USA which, though similar to ours, in the current climate may not be thought of as an ideal alternative.

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