

**REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS
BY DEREK HIGGS**

RESPONSE TO HIS 7 JUNE 2002 CONSULTATION PAPER

WHAT ABOUT THE CHAIRMAN?

- The Higgs Consultation Paper notes that over the last decade *“there have undoubtedly been improvements in the role and effectiveness of non-executive directors ... much of this improvement is attributable to the development and subsequent refinement of the Combined Code ... the culmination of work initiated by ... Cadbury ... Greenbury ... and Hampel.”*
- At the time of Cadbury I ventured¹ that *“Since it is the directors who run a company, they should be seen to take full responsibility for its affairs. Present convention dictates that annual accounts should contain a Chairman’s Review and the Companies Acts require a Directors’ Report. However the Chairman’s Review is a potentially lethal weapon when it is produced by a chairman who pays no attention to the rest of his board and the Directors’ Report is an anachronistic jumble of formal, small print disclosures. I would abolish the Chairman’s Review, move the Directors’ Report disclosures into the Notes to Accounts and create a new Directors’ Review which would be adopted by all the directors”*. I also suggested that the double standards which existed (and still exist) between annual accounts and prospectus requirements be removed by substituting the general going concern statement of the annual accounts with a much stricter annual working capital statement by the directors (ie a cash projection) as required by The Stock Exchange when a company is raising new equity or is involved in acquisitions or disposals.
- Had I thought of it at the time I would have added to the category of dominant chairman the equivalent risk of the over acquiescent chairman who accepts as his/her script (other than changes to style and grammar) what is provided to him/her by the executive. In both cases the non-executive director has little opportunity either to influence or sign on fully to the process.
- My own experience of company boards has been entirely positive – and it may be that there has been a general improvement over the years to full and effective engagement by non-executive directors. However, Equitable Life, Independent Insurance, Marconi et al would not appear to confirm this.
- In setting up a further review, the underlying presumption of the UK Government is that if corporate governance is further improved, there will be no more Enrons or Tycos or Equitable Lifes or Marconis. I have no argument with this in principle; but I have huge concerns that, as with previous reviews, it focuses almost totally on the non-executive director and the subjective subset of the independent non-executive director.

- My concerns are that in each of the reviews that have taken place, including the current one, there is little or no mention of the role and position of the chairman. Cadbury was the first to draw attention to the dangers of the chairman and chief executive being the same person and he and others have identified the need for board composition protections where this is the case. Yet those of us who sit on boards and who chair boards know the measurable difference between being chairman of a company and being one of its non-executive directors whether or not the non-executive director is a member of or chairs one of the board committees. The board chairman's terms of reference generally put him/her at the very centre of a company, determining the board agenda, working closely alongside the chief executive, being involved in the various interfaces with stakeholders and external advisers and communicating with directors collectively and individually. The chairman normally draws greater (sometimes much greater) remuneration than a non-executive director and, as I illustrate below, that remuneration may comprise an aggregation of basic salary, annual bonus, pension entitlement and share options – whereas the accepted remuneration for a non-executive director, (independent or otherwise), is a fixed annual fee.
- It is not, therefore, that the chairman becomes slightly more involved and knowledgeable than other board members. In certain cases he/she will be in a very different relationship to the executive, more privileged in his/her insights and much more connected with the day to day operations and decision making. I do not believe that this difference (ie the substantial influence/involvement of a chairman) has been fully recognised in any of the reviews and debates which have taken place to date; the Higgs review will achieve little if it does not address the chairman's role as a central issue in its deliberations and recommendations.
- However, the Higgs Consultation Paper does not auger well. In his Terms of Reference, there is no reference to "chairman", and in the Consultation Commentary there are around 55 specific references to "non-executive director" and the only reference to "Chairman" is that, in reviewing the performance of the board, "*non-executive directors should ensure the Chairman is aware of their views*". Not rocket science!

In the Consultation Questions which Mr Higgs poses there are 4 references to Chairman, but in each case it is in the context of comparison with the role and relationships of non-executive directors, viz:

- what is the role of the Chairman and how does it relate to the non-executive directors;
- what time commitment is needed for the role of Chairman and for non-executive director roles;
- to what extent are Chairmen creating the conditions for non-executive directors to be effective; and
- what should the relationship of non-executive directors be with the Chairman and Chief Executive?

(It is interesting to note that Mr Higgs appears to perpetuate the notion that the job of chair of the company is a male preserve; also, although he attaches a capital letter to "Chairman" and not to "non-executive director", he largely ignores the "Chairman" elsewhere in his brief.)

- Until the role of the chairman in the variety of forms in which it exists is properly debated and understood, I believe that little will be achieved by a further concentration on the increasingly beleaguered non-executive director. I found it very strange that the National Association of Pension Funds (“NAPF”) in their recent guide “Independent directors – what investors expect²” also virtually ignored the role of the chairman. The only reference to “chairman” among a number of thinly researched opinions and politically opportunistic recommendations about directors was that “*the NAPF regards it as the chairman’s role (assuming he/she is a non-executive chairman) to act as a channel for communication on matters of serious concern*”. Well, that’s going to sort out corporate governance once and for all!
- Looking at things from a different standpoint, the Company Law Review Steering Group posed the question in a March 2000 consultation document “*should the chairman be required by legislation or rules to be a non-executive director or even an independent non-executive director?*”. In their follow up in November 2000 they reported that “*the majority view was against prescription and for maintaining the Code disclosure requirements at least for the time being.*” Again, not much indication of serious discussion or debate about the chairman.
- The chairman is variously designated by companies as
 - chairman
 - executive chairman
 - chairman and chief executive
 - non executive chairman
 - part-time executive chairman
 - part-time chairman

I believe that confusion of definition and role is part of the problem. For example, in two similar UK FTSE 100 companies in the financial sector, the chairman of A has a basic salary/fee and the chairman of B has a salary, a bonus tied to long term executive bonus schemes and an entitlement to annual share options. They do similar jobs and exercise similar influence – but it may be felt that the chairman of B has aligned himself with the executive of the company in a way which makes it more difficult for the non-executive directors to function effectively.

It is not unusual to see something along the following lines in a remuneration committee report “*The executive directors have service contracts which can be terminated by the company on not less than one year’s notice. The contract relating to the chairman is for three years but if he is removed he will be entitled to only one year’s remuneration. The non-executive directors do not have service contracts*”. It is difficult to work out from this whether the chairman is in some twilight zone of his own between the executive and non-executive members of the board.

- The selection of a chairman can come from inside the company or by an external search, either using the company’s own network of contacts or a more formal out-sourced search process. There are two extremes: the person appointed may be someone who has had absolutely no previous connection with the company or it may be the incumbent chief executive. Somewhere in the middle is the “promotion” of a non-executive

director (independent or otherwise) or deputy chairman (executive or otherwise) into the chairman's role.

- As things stand, shareholders take no particular interest in this process of selection and, generally, that is as it should be. The board of a company, through its nomination committee, should have the relevant skills and experience to make the right appointment. However I am surprised that, for example, there has not been pressure from shareholders to put the promotion of a chief executive to chairman within the same company to a shareholder vote – requiring the board to set out the case for moving someone who was specifically recruited to lead the executive into a non-executive or part-time executive chairmanship. I would suggest that this requirement would make some boards stop and think and thereby reduce the risk of any inappropriate appointments being made. Equally, I am sure that some promotion proposals would receive an enthusiastic endorsement from shareholders.
- If it is considered that more should be done to improve the governance of UK companies, I believe that any review must start by looking at the role and influence of the chairman. The private shareholder sees only the chairman's statement and someone chairing from a distance at the annual general meeting; the institutional shareholder sees someone twice or more each year leading an executive presentation of results and analysts may demand to see the chairman as part of their appraisal of the company and its prospects. It is however within the boardroom that the real role and relationships of the chairman are evident and I do not believe that on the whole these are well understood. If non-executive directors are to take on fully the responsibilities asked of them, they need to stand four square with the chairman rather than apart.
- This would fit with the creation of a new Directors' Review to replace the Chairman's Review and the introduction of an annual working capital statement requiring all directors to look in detail at the reality of the company's situation as measured by its projected cash flows.

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¹ A Working Paper dated October 1991 for Heriot-Watt Business School entitled "Who Runs Companies? Some thoughts on the corporate governance of UK quoted companies," and a response to Cadbury entitled "Cadbury's half filled egg" for Scottish Financial Enterprise.

² NAPF 2002. The guide was produced by members of the NAPF's Shareholder Affairs Sub-committee, advisers and members of the Secretariat.