

Review of the Role and Effectiveness of Non-Executive Directors

Response of Deloitte & Touche

We welcome the consultative paper which you have issued as we believe that, in developing further the corporate governance framework for the UK, it is essential that it be based on consultation and consensus with the corporate sector, institutional investors and other relevant persons such as auditors. In summary our comments are as follows:

We concur with the view that there have undoubtedly been improvements in the role and effectiveness of non-executive directors over the last decade. We believe that the reason that this has happened has been the emphasis that has been placed on increased disclosure to enable more effective monitoring by shareholders.

Suggestions made by a few people, that compliance with Combined Code Provisions should be made mandatory, are misconceived. There are huge differences in the resources available to larger FTSE companies on the one hand and small cap companies on the other. In line with the 'think small first' principle adopted by the Steering Group for the Review of Modern Company Law, there is a need to put in place a regime which can fit the circumstances of all public companies. This is best achieved by way of a continuation of a disclosure-based rather than a detailed rules based regime. Revolutionary change and quick fixes (which usually bring about unintended consequences) should be avoided. Instead there should be evolutionary change building upon the reports of the Cadbury, Greenbury and Hampel Committees.

The UK 'balanced' unitary board structure system is working well. It enables non-executive directors to participate in the key decisions on an informed basis and to gain an understanding of the strengths and weaknesses of the senior management team. It should not be undermined by attempts to change the status of non-executive directors or to make them directly accountable to other stakeholders. We support the roles of non-executive directors as set out in the Cadbury and Hampel reports.

At the international level we do not see governance systems which are superior to that of the UK. Indeed there is much that many other countries can learn from the UK. However there is a need to recognise that, particularly as a result of scandals in the USA, the capital markets and the public are increasingly concerned about corporate governance, including the role and effectiveness of non-executive directors. There is therefore a need to avoid complacency and develop with the corporate sector some further areas for evolutionary change.

Such areas include:

- more transparency as to the basis on which non-executive directors are selected and encouragement for companies that advertise publicly for applicants to fill non-executive director vacancies;

- additions to the Combined Code Principles and Code Provisions in relation to an annual self-assessment by the board which would include an assessment of the time commitment and attendance at meetings of the non-executive directors;
- the development of guidance on the roles and responsibilities of board directors;
- a disclosure in the annual report of the reason for the resignation of a non-executive director before the expiry of his or her office;
- more disclosures on areas in which non-executive directors may be expected to be active but without undermining the unitary board concept. Examples include:
 - (i) the extent to which director training and briefings on the business takes place for non-executive directors and of the cost of such training borne by the company;
 - (ii) the process used to review and monitor a code of ethics as part of the statement on internal control;
 - (iii) the procedures for reviewing the process for dealing with whistle-blowing by employees;
 - (iv) the extent to which non-executive directors attend meetings between senior management and analysts. (Separate meetings directly with analysts and investors would undermine the unitary board concept and increase the risk of ‘market abuse’); and
 - (v) fuller reports on the activities of the audit committee including in connection with the preparation of the interim report and the annual financial statements and approval of the company’s accounting policies.

A growing problem is in obtaining and retaining good non-executive directors against a backdrop of increasing concern about the extent of potential litigation. In order to overcome this problem, there is a need to move towards a system of proportional, rather than joint and several, liability so that non-executives are not made liable for the faults of others. There is also a need to codify not only the duties of directors within the forthcoming Companies Bill but also the defence of taking reasonable steps to discharge the exposure to liability.

We enclose in Appendix 1 our responses to the questions set out in the consultative paper.

Responses to the Questions Set

- A1 The role of the board is to take responsibility for the governance of the company, to set the company's objectives and strategies and to monitor the company's performance. The objectives should be toward long-term sustainable profit rather than to meeting short-term earnings targets. The role of the chairman is to run the board and is a separate role from that of the other directors. The chairman should ensure that there is an effective relationship between the non-executive and executive directors.
- A2 The key roles of the non-executives are well described in the Cadbury and Hampel reports. A balance between executive and non-executive directors frequently works well but disclosure of the composition is preferable to attempts to develop rules in this area. As can be seen from Section 4.1 of our report 'Board Structures and Non-Executive Directors Fees' there are differences by size of market capitalisation.
- The primary role of the non-executives should be involvement in board decisions rather than to perform roles which would undermine the unitary board concept that is working well in the UK. A role that needs to be developed further is acting as promoters of good ethical behaviour to ensure that the company is run on behalf of the shareholders as a whole.
- A3 The above roles are similar to many well run companies at present, but there is some scope for improvement encouraged by more transparency.
- A4 A majority of the non-executives should be independent of management and of business relationships with the company. However there is a danger that, where they are all independent, non-executives will not contribute enough real challenge to key business decisions as they may not have enough feel for the business and its risks. Improved disclosure can help progress towards independence of fact but what really matters is independence of mind which is probably better influenced by more training rather than legislation.
- A5 The main conflicts arise through the increasing pressure on management to meet short term quarterly reporting expectations whilst also trying to set and maintain longer term sustainable growth. The non-executives can help focus attention on long-term sustainable growth. There is scope for more support and relevant training (e.g. training on effective questions which may be asked). Ultimately however, if a non-executive director believes that a conflict is not being resolved, he or she can resign. In such circumstances it would be useful for the shareholders if a statement of the reason for resignation is made in the annual report where resignation arises before the normal expiry of office.

- A6 The time commitment varies enormously. Much depends on the health of the company. Much more time is needed when things are going wrong. It is therefore not possible to make generalisations. However our research into non-executive directors of FTSE 350 companies indicates that relatively few individuals hold more than one directorship and only around 3% hold more than two.
- A7 Under normal circumstances, provided there is a separate chairman, no. However, if there is a lack of confidence in the chairman, there may be a temporary role. Also in large companies there may be a need to recognise a senior independent director who is effectively deputy chairman. However over 80% of the FTSE 350 companies have appointed a non-executive to this role, and therefore it is likely that there will be support for this role to act as an ‘emergency channel’ where there are particular concerns that only the non-executive directors can address.
- A8 Any attempt to distinguish the statutory duties of executives and non-executive directors would be very difficult and might undermine the unitary board concept.
- B9, 10 & 11 The main attributes needed include first hand experience of running a decently sized organisation and good meeting skills. A wide range of business related backgrounds is useful which could include experience of running government agencies or other large entities. Other attributes include honesty, common sense, ability to ask challenging questions and some financial literacy.
- B12 It is getting harder to recruit the best people. Recent litigation have already resulted in some of these people avoiding non-executive directorships. Extending the role of the nomination committee to recommending non-executive directors could help, plus more direct advertisements for potential applicants. Recruitment consultants tend to recycle the same people.
- There is a growing need to look at replacing joint and several liability which means that non-executives can be made fully liable for the actions of executive directors who are paid far more and may be far more responsible for what went wrong. The US system of proportional liability needs to be examined, as does a proper codification in the forthcoming Companies Bill of reasonable defences as well as of duties.
- B13 & 14 The fees for non-executive directors need to be reconsidered. See Section 5.2 of our report ‘Board Structures and Non-Executive Directors Fees’. At present such fees may frequently not be enough to justify the risks and responsibilities of non-executive directors which are increasing. Such directors could also be paid more in shares. Options would be inappropriate. Advertising should help get more applicants. There is also scope for some more international representation on UK boards.

An issue that needs to be dealt with is concern that the current law for protecting private addresses of directors is not effective enough.

- B15 D&O cover is getting smaller and more expensive to retain. The advent of class actions in the UK would be a disaster in terms of attracting or retaining talented non-executive directors. See our answer to B12 above.
- C16 The Combined Code is working well in practice. The disclosure requirements are effective in the area of board balance. Our research into the FTSE 350 companies indicates that in around half of these companies' non-executive directors account for at least 50% of the board. There may be scope for some more transparency of the operation of the committees but the key decisions should remain with the board as a whole.
- C17 Board meetings frequently depend on the chairman's ability. Board sizes are generally effective.
- C18 Audit committees are increasingly powerful but are at risk of overload because of being allocated tasks additional to financial reporting and auditing. There may be scope for some further transparency rather than more Code Provisions. Greater disclosure is more effective in developing real best practice than getting more rules which cannot fit all listed companies or their circumstances. Audit committees could look more into Codes of Conduct and internal whistle-blowing procedures.
- C19 More transparency is again better than more rules in this area.
- C20 & 21 The processes for board review are variable. Transparency would also be the best way forward perhaps supporting a new Combined Code Provision on an annual board self-assessment which could extend to the non-executive directors.
- C22 Good non-executive directors can achieve much in terms of influencing decisions. Exposing serious problems is harder – the best weapon is effective questioning. More training and guidance is needed on this. A disclosure in the annual report on the reason for resigning other than at the normal expiry of office would also help.
- D23 Relationships between non-executives and shareholders/stakeholders do not work well. The non-executives should attend more analysts' meetings (with executive directors) to hear what is being said from both directions. Non-executives should not attend separate meetings with analysts or institutions, as it would undermine the unitary board concept and put them at risk of committing 'market abuse'.
- D24 Chairmen are usually effective but there is more scope for training here also. Sir Adrian Cadbury's book would be a useful basis for such training.

- D25 The relationship should be based on openness and honesty. In the UK context this should not be done by separating executive management and non-executive directors now as is the case in some other countries. Relationships with key advisers will depend on the extent of involvement with board committees. This should not affect the right of a non-executive director to take separate advice.
- D26 This could be done by arranging more briefings for non-executive directors and a significant budget for director training. This should be encouraged by more transparency in this area.
- E27 The current system based on all full board membership works well. In the UK context two tiers would make non-executives much less effective as it would deny them real involvement in key decision taking.
- E28 & 29 More training is needed on how to do the job effectively. The Financial Reporting Council and the accountancy bodies could be asked to develop material for non-accountants to help their financial literacy.
- A Combined Code provision on board self-assessment would help.
- E30 Some more formalisation in this area would help.
- F31 Rules aimed at big companies will not necessarily work with small cap companies. The answer, as identified rightly by the Cadbury and Hampel Committees, is more transparency.
- F32, 33 & 34 The main lesson from abroad is that two tier structures are not the answer in the UK context. We are doing much that is right. The way forward needs to be evolution driven by transparency rather than radical changes or a plethora of rules which could well have unintended consequences. We should press hard for other countries to adopt UK style solutions, not the other way around.

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