

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

## **SUBMISSIONS IN RESPONSE TO CONSULTATION PAPER**

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### **Introduction**

I have taken a particular interest in corporate governance since my retirement from full-time employment two years ago. I have had the opportunity to read and analyse company reports in more depth and have been able to attend a wide range of company annual general, and other, meetings. I am aware of the work of the Cadbury, Greenbury, Hampel, Turnbull and Myners Reviews and have studied the Combined Code of Corporate Governance.

I am a solicitor enrolled in Scotland, a chartered secretary (financial and general administration specialisation) and a law graduate of Edinburgh and London universities. After a 31-year career in RAF Legal Services I was the Deputy Banking Ombudsman for 10 years until my retirement in 2000. I now hold two part-time positions. None of my career experience has been in the commercial corporate area but throughout I have been involved in the work of councils, committees, working parties and management groups. I have owned shares in a wide range of UK and foreign companies since first investing almost 50 years ago. From my work and interests I have, particularly within the last two years, developed views on how boards of public companies should be run and the role of non-executive directors in that function.

As my experience of corporate governance is essentially that of an outsider there are certain topics in the Consultation Paper on which I can have no informed and helpful view. These I shall omit but, for ease of reference, I shall maintain the numbering of the Consultation Paper. I shall conclude my response with a Summary of my suggestions.

## SUBMISSIONS

### A: Role

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

1. The role of the board is to guide and direct the forward strategy and to monitor the day-to-day running of the company. The board ultimately, collectively and individually, accepts responsibility for the accounts of the company, for the company's successes and failures, and for the company's relationship with its employees and shareholders, relevant regulatory bodies, the media and the public generally. The chairman's role is to set the agenda, to lead the board and to act as a catalyst to produce a good working relationship between the executive and non-executive directors. In relation to the non-executive directors he should ensure that they are actively involved, to the greatest extent practicable, in the work of the board and that they maintain a direct and questioning interest in the company's affairs.
2. Beyond the individual roles of non-executive directors as chairmen and members of remuneration, nominations and audit committees they should play a full role in the deliberations and work of the board. They are, under existing legislation, responsible, just as executive directors, for all actions – or inaction – of the board and that should not change. The Combined Code recommends that non-executive directors should comprise *“not less than one third of the board”*. It is arguable that they should be in the majority.
3. –
4. *“Independence”* should not be the difficult concept it appears to have become. Section A.1.5 of the Code of Best Practice (“the Code”) requires that *“ All directors should bring an **independent judgement** to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.”* At A.3.2 the Code provides: *“The majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.”* In my view, **all** non-executive directors should meet that standard of independence.
5. One of the principal conflicts of interest which can arise “within a company” is the tension between the executive and shareholders over executive directors' remuneration. As *“remuneration committees should consist exclusively of non-executive directors”* (the Code, B.2.2) non-executive directors have a part to play in this situation. They should ensure that there is a proper balance between pay

and other rewards and that Clause B.1 of the Principles of Good Governance (“*companies should avoid paying more than is necessary. . .*”) is observed. They should oppose the issue of share options to executive directors when the company’s share price is significantly depressed – a practice which patently fails “*to align [the executive directors’] interests with those of shareholders*” (the Code, B.1.4) as it allows directors to benefit from an eventual share price rise without any downside risk. Indeed, by declining to take up options issued earlier at higher prices, directors are given the opportunity by this device to acquire large holdings at ‘bargain basement’ prices. Non-executive directors could press for fairer methods of handling share options: some fairly revolutionary proposals come to mind but are not directly relevant to this Paper.

6. Throughout my years of full-time employment I regarded the job I was paid to do as the activity to which I devoted all my working hours (and more!) and I believe that should remain the general position for all ‘full-time’ employees, at whatever level. This will no doubt be regarded as an old-fashioned view and I realise that there are exceptions to this in the present day, from the company’s point of view to have the benefit of wide experience at board level, and from the individual’s point of view to ‘broaden the CV’ to his or her future advantage. The question does not distinguish between executive and non-executive chairmen. On the principle I have expounded above I consider that an executive chairman should spend virtually his entire working time on the affairs of the company, with, say, one non-executive directorship in another company in an entirely different field and, perhaps, an additional ‘social’ or public interest appointment. The emoluments generally paid to executive chairmen can only begin to be justified on this basis. A non-executive chairman should spend over the year a minimum of 80 working days on the company’s business. A non-executive directorship should represent a commitment of at least 40 working days. These minima may rise where a company’s interests are widespread, either by nature or geography, and where the director is chairman of one of the essential board committees. Also, when a director has business interests overseas his travel may be regarded as increasing the days spent on company business. Allowing for weekends, holidays, sickness and other non-employment activities, there are only just over 200 working days in the year. It follows that a non-executive portfolio should consist of a maximum of four directorships, one of which may be a (non-executive) chairmanship. Other considerations, such as the desirability of the non-executive director feeling that he ‘belongs’ and is ‘part of the team’, a need to avoid confusion between the activities, problems, aims, and personalities of each company, and the reduction of instances of diary conflict preventing attendance at board meetings and other company occasions, also predicate the numbers I have suggested as absolute maxima. I have gathered some examples of non-executive overload but it would be invidious to put these forward and this Review will have identified the worst examples.
7. The senior independent non-executive director has a function in focusing the concerns other non-executives may have about aspects of the company’s affairs. The views of non-executives should, particularly when a board meeting is not imminent, be channelled through the senior non-executive and the chairman to the responsible executive director. When the roles of chairman and chief executive are, exceptionally, joint it is vital that there should be an active senior non-

executive director: when the chairman is himself non-executive he will himself function as senior non-executive director.

8. The proposed statutory statement of directors' duties as set out at Annex C to Volume I of *Modern Company Law, Final Report* deals only with principles and not with practical guidance on the carrying out of a director's duties. It is correct that it should apply alike to executive and non-executive directors.

#### **A. 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?**

9. A non-executive director should have working knowledge of company accounting; the ability to understand a balance sheet and a cash flow statement; and the intellectual capacity to evaluate business decisions and to balance risk against potential reward. Contrary to a view often expressed by chairmen it is **not** necessary for a non-executive director to have previous knowledge of the business area or areas in which the company operates. Knowledge will develop in the conduct of the director's duties. The only essential skills are those relating to accounting.
10. The personal qualities and attributes needed are an incisive, inquiring mind; an aptitude for formulating searching questions and persisting until a satisfactory answer or explanation is forthcoming; an ability to relate to advisers, to shareholders and to staff at all levels, maintaining an interest in the skills, aspirations and problems of the latter; common sense; judgement; and willingness to listen to both sides of an argument. Good oral and written communication are also valuable in developing a meaningful role on the board.
11. A wide mix of experience and attributes on the board is obviously desirable. The comments at paragraph 13, below, are of relevance. I am unable to contribute examples of specific achievements of non-executives. However, there are circumstances where, I believe, non-executives could have assisted the board through their potentially closer relationship with the ordinary shareholder or the man-in-the-street. For example, the decline in the fortunes of Marks & Spencer some three years ago could readily have been anticipated by any shopper noting the decline in the quality of the merchandise. While the executive directors may not shop in, or have time to visit, the company's stores, active non-executives should have alerted the executives to the impending disaster.

12. Recruitment of non-executive directors appears to be essentially by self-propagation of the existing board. When groups seek to put forward a candidate for the board this is generally treated with derision. I assume that an individual shareholder, not being a former ambassador or other member of the great and the good, offering himself or herself for appointment to the board is unlikely to receive any warmer response. Not being aware of the procedures of nominations committees I am unable to offer any direct suggestion on how recruitment and appointment procedures could be improved.
13. The search for non-executive directors should be extended outside the corporate sector. Recruitment and appointment remains highly incestuous with the perceived qualification being directorship of another company of similar standing. This attitude overlooks the vast personnel resource of those with appropriate skills and qualities but without direct commercial corporate experience. The executive of a company should be capable of supplying the corporate experience and technical knowledge required; the non-executive function is more to monitor intelligently and to take a detached, objective view of the company's performance and strategy. A more alert, involved and inquisitive approach by non-executive directors would in all probability have avoided some of the recent corporate disasters experienced in this country and overseas. Retired members of the armed forces and the civil service, academics, lawyers and non-corporate accountants are among the underused resource in this connection. Consideration should also be given to the introduction of directors recruited from the staff: in addition to such practical contribution as they may be able to make there would be a morale boost to colleagues. Such an innovation would be an acceptable exception to the 'independence' rule.
14. The levels of pay currently offered to non-executive directors appear to be appropriate, providing the directors give the commitment I have described above. It is, as far as my knowledge goes, not usual to grant shares or share options to non-executives and, in my view, it is essential to their necessary degree of independence that their remuneration should be confined to a stated salary. Applying to indicated salaries a multiplier of the proportion which assumed working days bear to the full year it is unlikely that the level of pay is a deterrent to recruitment of 'good' non-executives. On a related point, non-executive directors should be required, within one year of appointment, to hold ordinary shares in the company to a specified value, say, 75% of their first-year salary.
15. I must confess to being in some doubt as to the meaning of this question although I suspect it may have a 'Turnbull' element. However, assuming it to relate to the risks to the company of loss caused by the misfeasance or negligence of a non-executive director then a company may wish to seek insurance cover for this. However, it seems an unlikely risk which the company may accept as its own insurer. I assume that companies also have insurance which covers the risks of injury to directors while on company business.

### **C: Structures and accountability**

16 – 22. As an outsider in corporate matters I cannot usefully contribute to this section.

### **D: Relationships with shareholders and others**

23. Non-executive directors are occasionally available for informal discussion with shareholders after AGMs but this is not invariably so. They are, perhaps naturally, reluctant to discuss company matters and are prone to refer one to an executive director. It is to be hoped that any views they pick up on these occasions will be taken into consideration at the next relevant board discussion. Unfortunately the impression one gets at AGMs is that non-executive directors are on the margins of the company's affairs and a little out of touch. There are exceptions: at the recent Vodafone AGM, the non-executive chair of that company's remuneration committee, gave in answer to a question from the floor a very clear exposition of her committee's work. Non-executive directors could provide a useful link to institutional investors – who appear to be the slumbering giants of the corporate world – by having regular, less formal, contact than that between the executive directors and major institutional investors. Executive remuneration is clearly a substantial area of concern to ordinary shareholders but there is little indication of the contribution of institutional investors to this debate. Perhaps there is a wish not to rock the boat in which the institution's directors are also afloat. Non-executives might be able to stimulate a healthy dialogue and encourage institutions to exercise their votes, hopefully in a responsible way, as recommended at paragraph 5.95 of the Myners' Review, *Institutional Investment in the United Kingdom*.
24. Chairmen could endeavour to increase the effectiveness of non-executive directors by calling on them more often to answer questions at the AGM. It is to be hoped that the inactivity – and, occasionally, air of apathy – of non-executives at AGMs is not indicative of their degree of involvement in board meetings and company affairs generally. This process could be assisted by allowing shareholders to direct their question to **any** non-executive director, his or her answer being supplemented, as and if necessary, by the concerned executive director. Such a procedure would concentrate the mind of a non-executive on keeping a broad interest in all the company's ongoing affairs. Non-executives should be encouraged by chairmen to visit different locations of the company's operations and to take an intelligent interest in all its activities. In these ways shareholders and the workforce might have a better opportunity of judging the effectiveness of each non-executive director.
25. Non-executive directors should have a close working relationship with the chairman, the chief executive, executive directors and senior management. They should have an initial induction period during which, on a planned but fairly flexible programme, they meet key executives and should have 'refresher' sessions at least annually. They should be encouraged to visit different areas of the company, with varying degrees of formality, but to

prevent excessive expenditure of executive and management time some co-ordination through the office of the company secretary would be necessary. Non-executive directors should be entitled to have the advice of key advisers to the company on a reasonably controlled basis.

26. Company secretaries can support effective performance by non-executive directors by keeping them fully briefed on company matters, and by suggesting suitable visits and events which would be helpful to them in the conduct of their duties. The annual report should include a table of the number of board and committee meetings which each non-executive was entitled to attend, together with the number of actual attendances by that director. Under best practice the annual report should also list **all** other directorships and public appointments of directors in their mini-CVs, indicating clearly whether each is an executive or non-executive position, and should not obscure the total number by use of such a word as "*including*".

#### **E: Support**

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

27. I have touched on this topic at paragraph 26, above. Non-executive directors should be provided with digests of information about the company's position and progress. Obviously information overload would result if **all** available information were passed to them and a sensible compromise should be discussed and agreed by the board. Non-executive directors, however, must not feel excluded from any company information and should be encouraged to ask for amplification in any area in which they consider it is required.
28. – 30. I am not in a position to comment.

#### **F: Smaller listed companies**

31. No useful comment.

#### **G: International context**

32. No useful comment.

## **SUMMARY OF SUGGESTIONS**

1. A non-executive director should hold, as an absolute maximum, no more than four directorships, one of which may be a (non-executive) chairmanship. (Paragraph 6)
2. A non-executive director should, by the end of his first year in office, hold ordinary shares in the company to a specified value, say, 75% of first-year salary. (Paragraph 14)
3. Non-executive directors should be remunerated only by salary, without entitlement to shares or share options. (Paragraph 14)
4. Recruitment should be extended outside the corporate sector. (Paragraph 13)
5. The annual report should state the number of actual attendances by each non-executive director at board and committee meetings as against possible attendances. (Paragraph 26)
6. The annual report should list all directorships and public appointments in the mini-CVs of directors, indicating clearly whether each is an executive or non-executive position. (Paragraph 26)
7. Shareholders should be entitled to have their question answered by any non-executive director of their choice at AGMs. (Paragraph 24)

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