

9<sup>th</sup> September 2002

Non-Executive Directors Review  
Room 2142  
1 Victoria Street  
London SW1H 0ET

**Response to the consultation paper on the review and effectiveness of non-executive directors.**

I am chairman of the Political Steering Group of the Quoted Companies Alliance. I have written separately to Derek Higgs and I enclose a copy of that letter. This is my formal response to the points raised in the paper.

**Page 5 17A “Overview”**

**A.1 – present role**

The role occupied by non executive directors has changed dramatically in recent years. The Hemple view, as quoted on page 3 point 8 “*contribution to the development of company strategy*” has been overshadowed by a “policing” role which has been placed upon non-executive directors by institutional investors.

**A.2 – future role**

Non executive directors should continue to give strategic and, indeed, other advice. If, as seems inevitable, non executive directors are to adopt ever more onerous policing responsibilities then they must be given appropriate powers and rights. These should include appointment of auditors and solicitors.

**B**

The policing role has skewed the knowledge, skills and attributes needed towards those embracing compliance and corporate governance. That is bad for companies because it locks out people who do not have specialist knowledge of corporate governance issues. Among the best non executives I know are a former academic and a newspaper editor. They have both contributed significantly to the many companies where they have been involved. It is, now, difficult for people without a non-professional corporate finance, accounting or perhaps even corporate law background to keep up with the constantly evolving, and very diverse, corporate governance rules. I

believe that the best people will be attracted if they are also offered proper protection, proper authority and, very importantly, regular training.

**C** – No. Non executive directors have insufficient authority and training.

**D** – Shareholders and bankers should be encouraged to have independent meetings with non-executive directors should they so require them.

**E** – Training, together with authority, particularly to appoint auditors, to chair remuneration committees and to appoint solicitors. Power to veto other advisory appointments. A non execs section in the report and accounts giving an opportunity for the expression of dissenting views and concerns.

**F** – The position with regard to smaller listed companies is vastly different, particularly in the fastest-growing section of the LSE, the AIM market. Some AIM companies adhere to proper corporate governance standards. However, they are under **no obligation to do so**. Non executive directors of AIM companies have virtually no power except that of resignation. As a consequence, many AIM companies are being exploited as lifestyle businesses at the expense of shareholders.

AIM companies should be required to adopt the same corporate governance standards as main market companies.

**G** – Not much. The “black letter” rules in the United States have shown themselves to be open to manipulation. Our “guidance” system seems to be much better, especially because guidance has almost evolved to have the same status as statute. Even where statute is concerned, the “principle” approach seems to work better. For example, the requirement for the auditor to give a “true and fair view” seems to work well. In particular, we should stick to our system of subsidiary accounting for reporting. That is so much more revealing than the “10k” approach adopted in the US because, the subsidiary accounting reporting process allows for much greater and more transparent interrogation of company accounts.

### **Detailed response**

#### **A: Role**

A.1. The role of the board is to ensure the success of the enterprise as devined by return to shareholders in terms of value and yield. It is also to ensure that the company acts in accordance with the law and responsibly within the social environment within which it operates. That environment embraces employees, suppliers, creditors, the economic effects on the host country and environment more generally as represented by mineral resources, the atmosphere and all aspects of pollution.

The role of the chairman is to ensure fair debate within the board; to give counsel to the directors, both non-executive and executive and to bring about resolution to dispute. The chairman is the most senior of the non executive directors and it is his or her responsibility to ensure that all directors, executive and non-executive, are fulfilling their roles properly; to intervene, in consultation with other directors, to remove directors if they feel it appropriate to do so, and to be accessible, with the other non executive directors, to shareholders, to potential partners (including acquirers of the business) and to other stakeholders.

## **A2**

Non executive directors have the same overriding responsibility as executive directors and that is to ensure the success of the enterprise. In recent years, non executive directors have been expected to act, in particular, as representatives of the institutional shareholders to ensure that various corporate governance rules are adhered to.

Non executive directors should bring different skills to the board. In today's climate they all need to have an understanding of their 'new' corporate governance role. As a group, they should bring a diversity of skills, such as finance, marketing, industry knowledge, stockmarket knowledge, communications skills, management ability, and economic (maybe global) understanding.

## **A3**

We live in a far from ideal world. The role of the non-executive director has become focussed on the institutional investor. Other stakeholder groups tend to be overlooked. Because of the overriding pressures on non executive directors to represent good corporate governance, there is a danger that non execs with broader skills will be excluded. In particular, I think of academics and others who can lift the sightline of the business.

## **A4**

Independence is a difficult issue. The board needs to get on as a group and should be composed of like-minded individuals. The board of an insurance company might be composed of people with a totally different mindset, for example, to that of a high street retailer. However, non executive directors do need to be able to exercise independence, and that can only come through careful selection and from giving them independent rights. Those rights must be linked to the right to appoint auditors and maybe other advisers; the right to conduct independent reviews and to have access to proper funding from the company without permission from the executive directors.

## **A5**

With the need for the board to act as a unit. Non executive directors must be people with an independent cast of mind, who are not afraid to rock the boat occasionally.

## **A6**

Time commitment may vary dramatically according to the company and the circumstances in which it finds itself. For example, in the case of an MBO the non executives become the company and can find themselves in a very time consuming position. They should be allocated substantial special fees for such time commitments. However, in the normal case of events, each company should take approximately 1½ - 2 days per month, approximately a day for the board meeting and preparation and up to half a day for other matters.

This implies that a non executive director could take on up to, say, ten or more such directorships, given 20 or so working days per month, excluding weekends and depending upon holidays taken. That's not unreasonable if he or she is doing nothing else and coincides with the number of companies which a stockbroker's analyst might be expected to follow, closely, on a regular basis.

## **A7**

Ideally the chairman should be the senior independent non executive director. However, where the chairman has close ties to the executive then there is a role for "senior independent" non executives.

## **A8**

Yes. A distinction between the legal duties of executive and non executive directors has evolved, with the onus for the management of corporate responsibility being placed firmly upon the non executive directors. Statute should reflect reality. All directors must have the same responsibilities but, specifically, it is the role of the non exec to monitor and to examine the activities of the executive.

## **B – Attracting and appointing non executive directors**

### **B9**

Covered in previous points.

## **B10**

Covered in previous points.

## **B11**

Partly covered in “Overview”. The role of Dennis (now Lord Stevenson) in the Manpower affair was particularly exemplary.

## **B12**

It is difficult to read just how the new threats to non execs which have resulted from Equitable Life, in particular, will play through. As I understand it, potential non executive directors are often, now, advised by their personal solicitors to be extremely careful about the roles they undertake. A lot of the problem with regard to public quoted companies in the past has been that the same people have been appointed to too many posts. All too often that’s because they have been the sort of people that most other people least object to. In other words, they achieve their popularity as non executive directors by being reluctant to rock the boat. That is extremely dangerous. Nomination committees need to seek out people who are less malleable and are less likely to be influenced by self interest.

## **B13**

The pool can be widened by reaching, in particular, into the academic and communications worlds to help companies lift their heads to examine the broader issues. The constraints relate to bringing together people in the right balance to ensure that there is sufficient strong business and management representation on board.

There is not only scope but a great need for greater international representation on UK boards, particularly European representation.

## **B14**

Remuneration is a difficult one because there is no doubt that non executive directors’ independence can be corrupted if their rewards are too closely linked to the success of the operation. Options and shares may encourage them to turn a blind eye to bad practice. On the other hand, where non executive directors to make a significant contribution to the success of the business, as the sometimes can, then they should benefit from that.

Cash remuneration and bonuses seem to be the answer. In view of the risks non execs may suffer, current pay levels are totally inadequate. They need to increase by a multiple of four or five.

## **B15**

The Equitable Life affair has (or should have) caused non executive directors to be very nervous indeed. Adequate insurance is absolutely vital.

## **C16**

The Combined Code works, with the possible exception of the AIM market. Further definitions should relate to the right of non executive directors to appoint auditors, in particular. It should also lay responsibility upon companies to ensure that directors have proper contracts and are properly insured, which is not always a matter for negotiation.

## **C17**

Yes, with the exception of the same companies.

Board size depends very much on the size and geographic spread of the business. The board as a whole should include executives of main operating subsidiaries.

## **C18**

It is essential. The audit provisions seem to be working well, again with the exception of AIM companies. The main need is for non execs to appoint auditors and have auditors report directly to them.

## **C19**

Audit committees seem to work quite well but remuneration committees are not working. There have been scandalously excessive remunerations granted to chief executives. Part of the problem is that the trend to appoint chief executives from one company to be a non executive director of another causes backscratching mentality to develop. It's easy to see chief executives acting as non execs thinking "if I give him a large salary then it justified mine as well".

## **C20**

Varies according to individual companies. There is a regrettable tendency to remunerate directors according to the size of the business. This encourages directors to push for larger companies to justify bigger remuneration. That is good neither for the economy nor for shareholders. The size of the job is often distorted. A clear example of this is the water industry where the same people were paid two, three and four times the salaries when companies were made public. They had no greater executive responsibility, they just took more

money. New methods of assessing performance need to be found and those methods should relate to the performance of the business as an entity against a number of benchmarks, including stakeholder measures. The suggestion that good business brains will be poached overseas if they are not given super remuneration is rubbish and has no substance.

## **C21**

Yes to all three questions.

## **C22**

Not necessarily – at the bottom end of the market and in AIM companies of very limited ability. It should be made much easier to do so by giving them powers to conduct forensic examination, financed by the company, where they have a suspicion that wrongdoing is taking place.

## **C23**

Relationships to shareholders and others. Relationships between non executive directors and shareholders maybe either very good or non existent depending on the nature of the company. Relationships with stakeholders are almost universally non existent.

Non executive directors should be required to make themselves available to shareholders and to stakeholders at separate events conducted (without the non executive directors present) after the AGM.

Instead of skipping off to lunch after the AGM they should be required to notify all stakeholders that they will be available throughout the day. Ditto for shareholders, in private meetings to follow the AGM.

Non executive directors' individual contact details should be published in the annual report and accounts so that they can be contacted by stakeholders and shareholders in private if need be. Email addresses would give best security.

The success of the chairman depends on the company. In many companies a lot more could be done. The key is to have a strong chairman who is independent. Failing that, a strong independent non executive director is needed to encourage debate and to give confidence to the non executive directors.

## **C25**

Non executive directors should be on familiar terms with executive directors and senior management but they should also be capable of exercising

independence and not be frightened to “rock the boat”. The chairman should be a non executive director and other non execs should work with the chairman. The role is to police the activities of the chief executive but at the same time to assist the business. They should have close relationships with key advisers and should have private meetings with each of them at least once a year.

## **D26**

The role of the company secretary can be anything from crucial to almost irrelevant. As a general rule the company secretary reports to the chairman but, where the chairman is non executive or is not closely involved with the business on a day to day basis, the company secretary can find that life is very lonely and difficult if he or she is helping the chairman to exercise true independence. Regard should be given to pulling the company secretary’s day to day administrative roles within the company and to creating a new type of company secretary who would work for a number of companies’ non executive boards in the same way that corporate trustees operate today. A ‘corporate’ secretary.

## **E27**

Non-execos need accurate and unbiased information and very often don’t get it. Communication flows are neither open nor unrestricted in many companies.

## **E28**

Training and development is vital and non execos should have the right to at least two days’ training a year built into their contracts.

## **E29**

Non execos should be required to go through, and should be paid for, comprehensive induction processes of relevant duration, depending upon size and complexity of business

## **E30**

Non executive directors are expected to police themselves and the question is, who will give them the feedback on what they are achieving? Where are the benchmarks? I suggest that the non execos should be given a section in the annual report in which they can report upon governance and other issues and also express their, perhaps dissenting, views on a range of issues but executive pay in particular.

### **F 31 Smaller listed of companies**

Smaller listed companies and AIM companies in particular should work to the same standards of corporate governance as large companies. In fact, there is an argument to say that standards should be higher because those companies are very often much more closely controlled by executive directors who are also dominant shareholders. Other shareholders need protection and they are not getting it.

### **G International Context**

#### **G32**

Not much.

#### **G33**

Don't know.

#### **G34**

The UK seems to be setting the pace quite successfully.

**Brian Basham**