

Review of the role and effectiveness of non-executive directors

We are pleased to respond to the above-titled Consultation Paper published on 7 June 2002. We are a commercial law firm practising corporate law in the City of London, nationally and internationally through fully integrated offices in France, Germany, Italy, Brussels and Hong Kong. We act for both large and small listed companies, but historically our client base has included particularly small and medium sized listed companies. Such clients look to us for commercial, rather than purely legal, advice, and we have a particular reputation for being business advisers in that context. We feel that we particularly understand the position and requirements of small and medium sized companies and are therefore especially qualified to comment in relation to those companies.

In view of our particular expertise, we have focused on the following two sections of the Consultation Paper:

- A: Role: What role should non-executive directors perform, and how does this compare to the present position; and
- C: Structure and accountability: Do existing structures and procedures facilitate effective performance by non-executive directors?

We have as requested included in our consideration the following factors raised by the Consultation Paper:

- F: In what ways is the position different for smaller listed companies; and
- G: What can we learn from international experience?

We have restricted ourselves to key points. This is a large and complex issue and it would be possible to address it from an academic legal standpoint. We do not believe that such an approach would assist the Review Body. We are cognisant that the Government's preferred starting point is an approach based on best practice rather than regulation or legislation (Annex A to the Consultation Paper). We have therefore refrained from proposing amendment to existing legislation governing directors' duties, acknowledging that such a process has already been undertaken as part of the Company Law Review.

Overall Conclusions

Our key conclusions reached in this response are as follows:

- in reality, the non-executive director often fulfils more than one role. He or she is expected to procure compliance with the provisions of the Combined Code, as well as being an advisory director bringing business experience to the Board. A distinction should be made between these roles and different principles should apply to different roles;

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- those directors whom we categorise as supervisory directors must be strongly independent, must have enhanced rights to demand information and to report concerns, and should meet as a separate body, either a supervisory board or a supervisory committee;
- to prevent suitable candidates being deterred from non-executive appointments, the law should be clarified (in the proposed statutory statement of directors' duties) to make it explicit that a director's role will be taken into account in determining his or her liability for negligence or default.

Our specific comments, by reference to the lettering and numbering of the Consultation Paper, are as follows.

A: Role

A1, A7: We believe that the Chairman of the Board should be a non-executive director.

The role of the Chairman is essentially to manage the effective operation of the Board itself. We believe that this is incompatible with an executive position and agree with the Combined Code principle that the roles of Chairman and Chief Executive should be separate. We also feel that it is almost inevitable that the Chairman will be the senior non-executive director and that the title and position of "senior independent director" is unnecessary and confusing and should be dropped.

A2, A3: We believe that non-executive directors fulfil different roles, and sometimes more than one role. This is not reflected by law or regulation, but should be, because it is commercial reality.

Non-executive directors currently perform one or more of three principal roles:

- the role of contributing to operational management, often at a strategic level, through industry or City experience, personal contacts etc. We refer to this as an "advisory" role;
- the role of representing the interests of significant (or even, in the case of many smaller companies, controlling) shareholders. We refer to this as a "representative" role;
- the role of monitoring and supervising executive management and seeking to ensure good corporate governance. We refer to this as a "supervisory" role.

The supervisory role has been imposed on non-executive directors by regulation such as the Combined Code, but there has been no corresponding modification to the legal duties or indeed rights of non-executive directors to reflect this change. We believe that the inherent difficulty of combining two or more of these roles is increasing. We also believe

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that formal recognition should be given to the "supervisory" role, at least, with perhaps the creation of a specific designation of "supervisory director". The supervisory directors should be subject to a number of specific requirements and have specific rights as follows:

- the supervisory directors should meet separately, either as a supervisory committee, perhaps before full Board meetings, or perhaps as a separate supervisory board (as is already the case in some European jurisdictions such as Germany);
- the supervisory directors should be required to be strongly independent (see below);
- the supervisory directors should receive regular performance reports from management, considering performance against specific corporate governance and internal risk management yardsticks. They should also have the right to demand particular access to information and/or to management (see below);
- the supervisory directors should publish a specific report on the matters for which they are responsible as part of the company's report and accounts.

Aside from independence, there should also be some minimum level of "qualification" for the role of supervisory director, analogous to that required for the company secretary of a listed company. One possibility would be to require membership of an organisation which would grant accreditation to individuals, perhaps a new organisation or perhaps an existing organisation such as the Institute of Directors.

There would be no reason why an advisory director could not also be a supervisory director, provided the requirements as to independence were met. In smaller companies we envisage that such a duplication of roles would inevitably continue. In larger companies, we question whether advisers who do not wish to take on a supervisory role will wish to take Board positions in future, perhaps preferring to be retained simply as consultants or similar.

Further consideration needs to be given to the position of representative director which is, and always has been, a difficult one because of the potential for conflict of interest between the shareholders as a whole and the appointing shareholder. However, it seems to us unrealistic to expect that major shareholders will not continue to insist on "representative" appointments.

A4: We believe that strict guidelines defining "independence" for supervisory directors should be a part of the Combined Code.

We feel that the necessity for supervisory directors to be independent lies at the heart of the supervisory role and needs to be significantly reinforced. Historically the actual or

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perceived partiality of some non-executive directors has been of a nature such as to call into question the validity of that role. Anecdotal evidence abounds of former management, relatives of management, former business associates and elderly or infirm individuals holding non-executive posts. If genuine independence can be established as best practice then this would be a very significant step forward in the perceived effectiveness of the supervisory role of non-executive directors in the UK.

This view leads to the difficult question, what should be the criteria for independence? We do not seek to offer a complete answer in this response. Nor do we think it is sensible to bar entirely individuals who have had a previous business association with the company or with its management. The following tests do occur to us:

- not a "connected person" of any other director of the company, such as a family member;
- not a recent former adviser to the company (we note the US approach requiring auditors to be retired for 5 years before appointment to the board of a former audit, for example);
- not have or be interested in a significant shareholding;
- not be the "representative" of a particular shareholder or group of shareholders;
- not also be currently on the board of a company which is a material customer, supplier or competitor.

These would be in addition to existing strictures applying to all non-executive directors in respect of not receiving share options, pension benefits and the like. An alternative approach however might be to draft a "principle" of independence and to give non-exhaustive examples of the application of that principle, such as those listed above.

A6: We believe that further consideration should be given to a maximum number of directorships held.

As a matter of best practice, non-executive directors should spend sufficient time on the role to ensure that they fulfil it properly. As a crude rule of thumb, that would suggest to us that 4 or 5 non-executive positions would be the maximum feasible even for an individual who had no other material demands on his or her working time. In some cases however, the nature of the company, the composition of its board and other factors could mean that much greater, or lesser, time commitment than the average was required. A supervisory director of a FTSE 100 company would probably be expected to devote considerably more time to the role than would be the case for a small or medium sized company. Clearly this will be reflected in remuneration levels. We would therefore suggest that a maximum number of directorships should be set but that the amount of time to be spent should be left for the individual company to determine.

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In Germany, for example, the number of memberships of supervisory boards a person may generally have is limited by law to 10. This is to ensure that sufficient attention is paid to each position and also to avoid the influence of supervisory board members being restricted to a small circle of people.

A8: Comment on proposed statutory statement of directors' duties.

The proposed statutory statement is designed to provide directors with a clear statement of what are currently common law duties. The reaction of non-executive directors to recent litigation has suggested that knowledge of the application of these duties to the non-executive role was limited. The proposal is therefore to be welcomed. However a number of bodies have reported that the fact that non-executive directors are now cognisant that they are potentially as liable as any other directors for their actions has resulted in difficulties in filling non-executive vacancies. Arguably the present subjective/objective test of responsibility for directors distinguishes sufficiently to give non-executive directors some protection from the standards which may be required of executive management - but the position is unclear. We would recommend the insertion of an explicit statement that in assessing the skill, care and diligence to be expected of a director regard should be had to his or her role on the Board including whether he or she occupied an executive or non-executive position. (One could of course also argue that perception of the increased "seriousness" of a non-executive role is a not wholly undesirable change if it brings about higher standards and the elimination of some weaker candidates from the prospective pool of non-executive directors.)

C: Structures and accountability

C1: We would retain the Combined Code, with some specific changes.

We are sponsors of a review of corporate governance issues by Edis-Bates Associates which was published in January 2002 and supplemented by an interim report published in June 2002 ("the Edis Bates Review"). This included a review of the annual reports and accounts, AGM notices and policy statements published by FTSE 100 and FTSE 200 companies in 2001 and early 2002 and a survey of their company secretaries asking them how they intended to address certain key corporate governance issues in their annual reports and accounts to be published in 2002.

Of the companies whose 2002 annual reports were reviewed, 43% disclosed that they had complied fully with the Combined Code. The compliance level for the FTSE 100 companies was 40% and for the other FTSE 200 companies 45%. The main issues for consideration are both the low level of compliance and also the often unsatisfactory level of information about non-compliance which is made available. We believe that further research should be undertaken to ascertain to what extent companies are complying with specific obligations under the Code such as those relating to non-executives. In the event of widespread non-compliance consideration should be given to making those elements compulsory.

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We consider that the guidelines contained in the Combined Code for the involvement of non-executive directors on the Board are generally sensible and generally followed by companies. However, we have identified a number of specific changes to which we believe consideration should be given:

- we suggest that Chairman should always be a supervisory non-executive (see above);
- we suggest that the Code should distinguish between supervisory directors and non-executive directors fulfilling other roles. The majority of the Code's provisions would then apply only to supervisory directors;
- all supervisory non-executive directors should be independent, according to detailed guidelines (see above);
- the provisions that non-executives must comprise at least one third of the Board, and that the Audit Committee must comprise at least three non-executives, are overly prescriptive for smaller companies. We suggest that a minimum level of two supervisory non-executive directors is specified, with the preferred ratio being one-third of the Board. This would bring the Combined Code into line with what we believe is acceptable market practice in the case of many smaller quoted companies. It would then be possible to require that all supervisory non-executives sat on the specific committees (up to a maximum of, perhaps, four) and formed a majority on those committees;
- supervisory non-executives should be empowered to demand information and to publish a report to shareholders (see below).

C18: We consider that the suggested composition and duties of the Audit Committee are generally appropriate.

As mentioned above, we believe there should be specific recognition that smaller listed companies could operate the Audit Committee effectively with just two independent supervisory directors. In view of the recent concerns about the roles of accountancy firms providing audit services and the degree of mutual dependency with the client company that may arise, we consider it would be helpful for non-executive directors to have more specific guidelines for the relationship between the company and its auditors. While we do not consider that the principle of forced rotation of auditors over a three to five year period is helpful or indeed practical, we take the view that guidance should be given as to the amount of non-audit work the audit firm should be permitted to undertake.

However, we consider the proposal contained in the Company Law Reform White Paper - that directors should have a duty to inform auditors of any information that a director thinks or would, if he had exercised due care, skill and diligence, think the auditors need

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for the performance of their duties as auditors - imposes a completely unfair and impractical burden on all directors.

C19: We believe that the suggested composition and duties of the Nomination and Remuneration Committees are generally appropriate.

We have mentioned above our view that all supervisory non-executive directors should qualify as independent. We also consider that there is a strong argument for membership of the Nomination Committee to be entirely composed of supervisory non-executives, although clearly the Committee would need to liaise carefully with the Board as a whole to obtain its views.

C20: We believe that the framework provided by the Combined Code for setting objectives for directors is appropriate in principle, although in practice we consider that there has been insufficient transparency as to the basis on which companies have been implementing the guidelines.

In particular, we support the proposals contained in the government statement on performance-related pay released in March 2001; in particular, the proposals for performance graphs, disclosure of the specific criteria and targets adopted, disclosure of the constituent members of a company's peer group and the index against which a company's own performance is measured and an explanation of the balance between the fixed and performance-related elements of directors' pay.

The Edis-Bates Review (described above) revealed the following levels of compliance with these proposals:

- performance graphs: of the 100 companies whose 2002 reports were surveyed, only six published performance graphs in 2002.
- disclosure of criteria and targets: in their 2001 annual report over three quarters of companies surveyed provided details of their performance criteria and this percentage was expected to increase to about 90% in 2002.
- peer groups: in their 2001 annual reports only 14% of the companies reviewed disclosed their peer groups although this figure was expected to rise to 33% for their 2002 reports.
- performance-related element of pay: in the 2001 annual reports, only 26% of companies reviewed provided some form of explanation of the split between fixed and performance-related elements, although few of the disclosures were very specific.

By way of comparison it is interesting to note that the supervisory board under German law also determines the management board's remuneration. By law, the supervisory

board has a right to reduce the management board's remuneration if the company is not doing well, although this power is rarely used in practice.

C22: We believe that steps should be taken to strengthen the ability of non-executive directors successfully to challenge executive decisions or expose serious problems.

We feel that this is a key issue. It is related to many of the issues discussed earlier. For example we believe it would be easier for supervisory non-executive directors to challenge executive management if they were all independent and if they had regular and separate meetings at which they could discuss and agree a concerted view. However to us the core of this issue is the supply of sufficient and timely information to non-executives by management. We have already suggested a requirement for the provision of a regular performance review to the supervisory directors. It could be a requirement that supervisory directors be kept constantly aware of material developments in the company's business even if they were of such a preliminary or speculative nature that no announcement to the markets was yet required. Supervisory directors could be given rights to request information, to commission internal studies and reports, and to have access to management below Board level.

In many cases companies funded by private equity investment have performed better than similar listed companies. It would be interesting to have a comparative analysis of corporate governance compliance at such companies: we suspect that private equity funders, whose supervision is based essentially on extensive rights to information such as we have described, enforce high standards of corporate governance in their invested companies.

Again, it is interesting to compare the position in Germany, where the management board is obliged by law to report to the supervisory board regularly, in some cases every quarter, on business policy and planning, the profitability of the company, the general condition of the company and transactions which may have a material effect on the profitability or liquidity of the company. These reporting requirements have been strengthened significantly by legislation in recent years. Similarly in France, in companies which have adopted a supervisory board structure there is a legal obligation on the executive board to provide detailed financial and management information to the supervisory board on a regular basis.

We also believe that there should be a separate report by the non-executive directors in the company's annual report. This would encompass a review of the performance of management and of compliance with corporate governance standards. The dealings of executive management with the non-executives might be favourably influenced by the desire to receive a satisfactory report. (We acknowledge the opposite possibility, that such a report would become "standard wording", written by the executives and only nominally "ticked" by the non-executives).

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We hope that the above comments are helpful. If you wish to discuss any aspect of this letter please contact Richard Burns (Senior Partner) or Andrew Pike (Corporate Finance Partner) at this firm.

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