

**Submission on the Role and Effectiveness of
Non-Executive Directors**

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My submission on this subject is based on my experience of having been an executive director in two major international British companies, Redland and Consolidated Gold Fields over a period of twenty years, and then part time chairman of a number of other companies including Caradon, Y.J. Lovell (Holdings), Swedish Match, Lasmo and DS Smith. I have also sat as a non-executive director on the boards of Cambridge Electronic Industries, Courtaulds Textiles, LIMIT, Candover Investments, Newmont Mining Corporation (USA), Renison Goldfields Consolidated (Australia), Global Stone (Canada), Braas & Co. GMBH (Germany), South Western Electricity, and the British Coal Corporation.

I will not attempt to address all the issues you outline in the consultation paper. However I would like to pick out a number of issues which I believe to be key to improved corporate governance.

1. **Chairman**

It has for long been conventional wisdom that the chairman and the chief executive should be different people. This separation has not, however, been enforced. I believe it should be. Perhaps it should be a requirement for any listed company. When the roles are combined there is always a material risk that one person will have far too much power. Nothing short of compulsion will persuade some boards to divide the two roles, although in truth I suspect that it is not the boards themselves who feel strongly about combining the two roles but the incumbents in the chair.

Independent chairmen should be selected by a nominating committee made up of a majority of non-executive directors. The chairman should be paid a salary which permits him to give sufficient attention to the business which could, in some cases, even be full time. He should certainly be paid at least three times the amount of a non-executive's fee and in many cases more. However, he ought not to enjoy incentive payments as that would reduce his independence in judging appropriate remuneration for executives and make it harder to oppose executives prepared to run excessive risks for short term performance and hence the triggering of incentive payments.

2. **Appointment of Non-Executive Directors**

All non-executive directors should be chosen by a nominating committee consisting of a majority of other non-executive directors and thus not be chosen by management. They should always form a majority of the board and again I

would make that a listing requirement. Only when the chairman and the non-executive directors have the power through voting control to replace the chief executive and veto major decisions with which they profoundly disagree can shareholders expect to have their interests properly protected.

It has been suggested that a number of non-executives should always be independently elected by major institutional shareholders. On balance I disagree with this suggestion. I believe it would be difficult for institutional investors to organise themselves to find suitable people who will complement the balance of a wide range of boards. In the event that a board appeared to be failing it is of course fully within the power of institutional investors holding a significant proportion of the shares to intervene by exception and vote against incumbents, nominating their own replacements. Such action should perhaps be taken more frequently than it is, and institutional investors could be officially encouraged to intervene more often.

3. **Role of Non-Executive Directors**

I profoundly disagree with the view of the Hempel Committee who said that the primary contribution of non-executive directors is the development of a company's strategy. I believe it is for the chief executive and his executive team to develop strategy and for the non-executive directors to question it and either approve it or reject it. It is extremely difficult, and sometimes dangerous, for non-executive directors, who generally do not have in depth knowledge of their company's industry, themselves to propose strategy, but I believe they can constructively criticise and if necessary impose such delay as to force the executives into substantial revision of their proposals or a more persuasive explanation in support of it.

I believe the single most important role of the non-executive directors is to monitor the performance of the chief executive and his team and require change if that performance is inadequate. They are also there to ensure that the executives are adequately but not excessively remunerated, that the auditors are supported in any resistance they may put up to unsound accounting practices, and critically to review, if necessary blocking, significant proposals for capital investment and acquisitions. Clearly a decision involving a change of control is peculiarly their final responsibility to approve or reject. They also provide a valuable and secure sounding board for the executive to test their ideas on before going public.

To perform these roles it is necessary to choose non-executive directors dominantly, if not exclusively, from people who have had extensive experience of comparable industries to that which the company operates in. Academics, clerics, politicians, soldiers and other able people who can bring a wider view may have a marginal place within a board, but if non-executive directors are to be effective they must understand the issues with which the executive have to grapple and the

needs of the shareholders whom they represent. Otherwise they will lack the confidence and authority to oppose the executive when that is required.

It is important that the non-executive directors have the right to seek independent advice at the company's expense, including independent financial advice in the face of major but controversial decisions on acquisitions or change of control. Any statement of good practice should include a reference to this right.

4. **Conflicts of Interest**

Most conflicts of interest between executive groups and their shareholders tend to surround ambitions relating to the scale of the business and the levels of remuneration which can be extracted from it.

Almost certainly the reason why so many companies make large acquisitions, which as often as not destroy shareholder value rather than creating it, is because management are tempted to buy things in order to grow as their own careers are enhanced by the scale of the businesses which they manage. Although shareholders themselves can occasionally be a brake on these ambitions, particularly where further capital must be raised, the first line of defence must be the independent non-executive directors forming a majority on the board who see their roles as being representative primarily of the shareholders' interest.

Although excessive remuneration has become a serious issue in Britain, I believe the reasons for it are by no means confined to the effectiveness of remuneration committees. As long as remuneration committees are formed exclusively of independent non-executive directors, are chaired by one of their number who is not the chairman of the board, and have access to independent advice, then the worst of those excesses should be avoided. It is probable that the startling spiral of executive remuneration over the last decade has been significantly a function of the uncritical acceptance of consultants' surveys, often commissioned by executives and designed for their approval, combined with a naïve belief that it is somehow appropriate that everybody should be upper quartile, if not upper decile. The inevitable effects which we have all seen need not be repeated in a world in which remuneration committees are properly constituted, advised and required to provide shareholders with clear and complete reports. However I believe that if remuneration committees are to re-establish public trust in a more reasonable division of the spoils between managers and shareholders their members will need to spend a lot more time on working out more appropriate incentives for the executives.

5. **Independence of Non-Executive Directors**

The primary issue of independence is dealt with above through insistence that non-executive appointments be in the hands of a nominating committee dominated by other non-executive directors. The nominating committee should be

chaired by a non-executive director who might well be the independent chairman of the company. No non-executive director should feel that he owes his position to management and that its continuance depends upon their goodwill. This is not to suggest that the boards function better if they are in a perpetual state of tension between the executives and the non-executives, but it is clearly right that we should avoid too cosy a relationship.

It is probably right that non-executive directors should be limited to three three year terms and that any board that re-elects a non-executive director for a fourth term should have to seek a two-thirds affirmative vote at the AGM and give their full reasons for wishing to renew the appointment. No matter what the benefits are of long experience of a company's affairs, true independence can start to become blurred after a time and on balance it would be better to be rigorous about a nine year cut off date.

6. **Time Commitment**

Time commitment for a non-executive director, after he has initially familiarised himself with the business, is not just a function of the number of board meetings he attends and the length of the board papers. Additionally, he is bound to be a member of at least one and probably two board committees, he should allow some time each year for further operational visits to improve his understanding of the business, and one must allow for the occasional serious issue which requires special meetings to be called, sometimes with extensive reading in preparation. It is also, in my experience, exceptionally valuable for a board to meet several times each year in the relative informality of either a dinner the night before a board meeting, or on some other informal occasion which allows lengthier and more relaxed discussion, often privately with the chief executive alone. It is hard to say how many full working days a year all this represents but I believe it is seldom less than fifteen and more often about twenty. Boards who meet once or twice a year abroad, because they have an international business and this is valuable for improved board understanding and exposure to overseas local management, probably needing to add three or four days to that.

I believe no working executive in another company should sit on more than one other board. Few do. The more difficult question is how many boards can be sat on by a retired or 'full time professional' non-executive. I see no reason why this should be restricted to some arbitrary number. A hard working full time professional could manage five or more, plus a chairmanship. It all depends on what else he is committed to. In a crisis, the busy full time professional non-executive is often the man who can and does make a lot more time available at short notice where it is urgently needed.

The chairman, doing a thorough job of keeping close to his chief executive, paying visits on a fairly regular basis around the business, reading a good deal of material at a stage prior to its exposure to the board, and getting involved in a

number of special exercises where his personal experience may be of particular value, is unlikely to do the job well in much less than fifty days a year. When a new chief executive is appointed or there are serious issues related to the chief executive's performance, and when there is any question of significant corporate activity, fifty days may well be a material under-estimate. From personal experience, I think it is quite challenging to be chairman of two substantial public companies, but perfectly possible. Three undoubtedly runs the risk that in the event of two having significant issues at one time the chairman finds it very difficult to meet all his commitments. I therefore believe that more than two chairmanships should be discouraged.

7. **Remuneration**

Most non-executive directors of fairly substantial PLC's in Britain today are paid somewhere between £25,000 and £40,000 a year inclusive of their committee fees. Smaller companies often pay significantly less. There are some large companies who pay significantly more. Presumably these levels of remuneration represent a market judgement on what it takes to get suitable people to serve. Whether the recent examples of damage to non-executive directors' reputations when companies have failed, and indeed the more spectacular risk of being sued, will change market clearing rates for non-executive directors remains to be seen. I suspect that it will, and rapidly.

I believe it would be appropriate to encourage higher levels of remuneration for non-executive directors anyway in order properly to recognise the time, responsibility and risk involved in the job. The problem in judging the 'appropriate' level of fees is the fact that most non-executive directors are either full time employees of other companies or, increasingly, retired executives with either pensions or personal wealth which permits them to regard non-executive director commitments as something akin to pro bono service. One significant group of non-executive directors who do not fit into this category are those that have retired from full time employment early and decided, or in some cases been forced, to take non-executive work rather than fresh full time employment. They are often the people who have many directorships as otherwise they can get nowhere near the levels of remuneration that they enjoyed in full time work when account is taken of the absence of incentives, benefits and, above all, pensions. Thus if it is desired to expand the pool from which non-executive directors are drawn and to encourage them to serve on fewer boards to which they can give more time and attention, official support for higher levels of pay can only be helpful. Because most people respond to what they regard as fair remuneration, non-executive directors are also more likely to put the necessary time into the job if they see themselves being paid at a rate which recognises their time commitment.

How big an adjustment is appropriate is a highly subjective judgement. My personal view would be that, if the central band of £25,000 - £40,000 moved up to

£40,000 - £60,000, we would have gone a long way to achieving a more appropriate balance.

The problem with the remuneration of chairmen is rather greater, in my view. It is not only the far greater commitment of time that the chairman has but also the far greater responsibility. He most certainly cannot forget about the business between board meetings. He needs to be on top of what is going on continuously. It is very likely that a number of important programmes for each company will be driven to some degree by the chairman's personal involvement. Again the range of payments to chairmen is wide but most reasonably substantial public companies appear to pay somewhere between £80,000 - £150,000. In my view the range should be more like £125,000 - £250,000 depending upon the scale of the business, its complexity, what precisely is expected of the chairman in each individual situation, the risks associated with the business, and the market forces that surround the quality of the individual chairman.

8. **Senior Independent Non-Executive Director**

Even in a company which has an independent chairman separate from the chief executive there is a role for a senior independent non-executive director. It can certainly happen that the chairman and the chief executive come at some point to be at odds with a minority, or perhaps a majority, of the non-executive directors. In such circumstances any independent non-executive director ought to know to whom it is he should address himself with his concerns if he feels he cannot go to the chairman about them. The same is true for shareholders.

9. **Directors' Duties**

I believe there should be some legal difference between the duties of an executive director and the duties of a non-executive director. Although the collective responsibility of the board for its actions should not be impaired, the standard of knowledge of what is going on inside a business required of an executive director should be clearly distinguished from that of a non-executive director.

10. **Recruitment of Non-Executive Directors**

I have never found it difficult to recruit non-executive directors of an appropriate quality. Clearly from time to time one makes mistakes, but the head hunting mechanism at least provides one with a wide choice from which one ought most of the time to be able to find suitable people. When a company is in crisis this may not be the case and it could then take special arrangements, perhaps with the help of one or two key major shareholders. On the whole I don't think that Britain lacks a suitable pool of non-executive director material.

As noted above, I think we should be very careful before we seek to bring many people who do not have a senior business background on to a board, but clearly

international business experience can be of great value in some circumstances. However, again one doesn't want to overdo it because those who travel from abroad are frequently not available for committee meetings not timed to coincide with board meetings and for less formal get-togethers. Most boards, unless they are really rather large, may well find it quite inconvenient to have more than one foreign resident.

11. **Insurance Provision**

Most companies as a matter of course provide directors' and officers' liability insurance. It is deeply disturbing that in one recent spectacular case, Equitable Life, it turned out that the insurance did not provide cover when one assured sued another, ie the new board sued the old board. It would seem highly desirable to increase the availability of directors' and officers' liability insurance, broaden its coverage and make its availability on a generous basis a listing requirement. Whether some artificial stimulant needs to be provided to the insurance industry to meet this challenge I am unclear.

It would also be desirable to drop the Inland Revenue's insistence that where a company indemnifies a director and then pays for his defence when he is sued, the payment for the defence is regarded as a taxable benefit. It also seems to me to be unreasonable that insurance does not cover a director found guilty of wrong doing so that, in the event that a director is tried and found guilty, insurance that he has up until then provided cover for his defence is immediately repayable and he goes bankrupt as well as going to jail. All too often the issue is not one of clear cut criminality and the double jeopardy imposed by such insurance rules represent a serious risk. Finally, if legislation capped a non-executive director's personal liability at, say, three times the cumulative after tax fees he has been paid, it could well reassure otherwise reluctant recruits.

12. **Board Committees**

On the whole the structure of board committees now regarded as standard, that is to say a remuneration committee, an audit committee and a nominating committee, does seem to work pretty well. There is reasonable time for due enquiry at an audit committee, though no enquiry is going to unearth wrong doing if the auditors haven't caught it themselves or choose not to query it.

It may be argued that the most useful 'committee' is a meeting of the non-executive directors with the chief executive alone without a formal agenda. More thoughtful debate can be conducted on these occasions than at most formal meetings. It is also valuable for the non-executives to meet by themselves occasionally. Official approval of this practice would encourage more boards to make it a routine event and thus not raise executive hackles when it is proposed.

13. **Size of Boards**

The size of boards is very much a matter of taste. In my own view, six or seven non-executive directors is as much as you need, producing a board of no more than ten to twelve in total. Boards much larger than that tend to find decision making increasingly difficult. Smaller boards, with perhaps three executives and four non-executives, generally work best.

14. **Relationship with Shareholders**

It is uncommon for non-executive directors to meet the major institutional shareholders of the company. It is good practice for the chairman to attend some of the meetings between the executive directors and shareholders after figures have been announced. I think there should be official encouragement for that practice. However it isn't practical for non-executive directors to join those meetings. Perhaps the right solution would be to hold a meeting once a year at which at least the top ten shareholders were invited to send a representative who were expected to comment in the presence of the full board on how they saw the performance of the company and the issues they had with it, followed by a period of discussion in the absence of the executives. Such an exchange of views could be very beneficial.

15. **Adequacy of Information going to a Board**

This is primarily the responsibility of the chairman to get right in the few cases where the chief executive does not volunteer everything that the board needs. It does not seem to me to be an issue for external intervention. If a board with a majority of non-executive directors is persistently under informed then it has the remedies within its own hands. It can either threaten the chief executive with being replaced or refuse to conduct the business of the company until he provides them with adequate information on which to base their decisions.

16. **Divorce between Ownership and Management**

Many voices urge that the fundamental flaw in modern Anglo American capitalism is the divorce between the owners of companies and their managers. Because the owners are now dominantly institutional shareholders and the managers dominantly hired guns, there is a widespread view that the institutional shareholders do too little to assert their rights to be listened to and the hired guns get away with murder, not only on remuneration, but also on other acts such as major acquisitions and insufficient attention being paid to creating shareholder value.

I agree that this dilemma does lie at the heart of most of the problems which have cropped up with the governance of companies on both sides of the Atlantic. However, my personal experience has led me to the view that most of the people

who become non-executive directors of public companies in Britain act in a way they feel to be in the best interests of shareholders. Where companies have operated in a manner which is palpably not in the best interests of shareholders, the reasons normally lie in boards with a majority of executive directors, non-executives who are not as independent as they should be, and a dominant chief executive, sometimes doubling as chairman, driving an agenda all his own. It seems to me that the appropriate response to such risks is to enforce the requirement for an independent and separate chairman, a majority of independently chosen non-executive directors adequately paid to give adequate time to the business and better communications with shareholders. A more thoughtful approach to comparative remuneration figures and the design of incentives on the part of remuneration committees would also help. Excessive remuneration packages can drive a short termist attitude on the part of the executives, particularly where very large stock options are available to them after only a three year holding period.

No doubt it would be better if the institutional shareholders, who make up the great majority by value of the owners of British plc's, took a closer and more continuous interest in the affairs of the companies in which they invest, but that is to expect something which they are not organised, or indeed constituted, to provide. Legislative enforcement of institutional activism has grave dangers. Insurance companies and pension funds are simply not going to be able to behave as Mr Warren Buffet behaves by investing large sums in a narrow portfolio of companies and then keeping a very sharp eye on their investments with a view to long term value enhancement. I am therefore not comfortable with proposals based on requiring more institutional shareholder involvement in the decision making of companies, other than in a crisis. What I think they should do is simply not to tolerate material deviation from a sensibly strengthened guide to good corporate governance practice. Their enforcement of good practice on boards should be backed by the powers of the listing authorities.

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