

Key matters

Introduction

We have already welcomed the proposals in the Company Law White Paper for the inclusion in legislation of a statement of directors' duties. We hope that this will help to specify, in modern terms, the duties of directors and to further improve the corporate governance framework. We do not, however, believe that it is necessary to further underpin the role of the non-executive director in statute, subject to our comments on the liability issues for non-executive directors set out in Section 3 below. The Combined Code is more flexible and can be updated more quickly to deal with issues relating to non-executive directors.

1. Confidence in the capital markets

The fallout following Enron and WorldCom has helped to cause a substantial loss of confidence in the capital markets. Many of the issues surrounding these failures stem from the conflict of directors' interests between their fiduciary duties as a director and the pressures on them to meet the short-term and other expectations of the markets. The achievement of short-term targets, such as revenue, EBITDA or earnings targets, subsequently triggering very substantial incentive payments and/or share options for executive and senior management, have been demonstrated to be a key driver of behaviour.

One of the key roles for the non-executive director, in helping to restore confidence in the capital markets, is to ensure that they focus attention on the realistic expectations of the shareholders. By taking a dispassionate view and seeing the company through the eyes of a longer-term investor they must maintain the board's focus (and the executive's incentives) on what is good for the company, the shareholders and the stakeholders, even if it is not good personally for the executive directors in the shorter-term.

2. The pool of potential non-executive directors

Being a director (executive or non-executive) of a listed company is no easy task. Not only does business have to operate in a highly complex, competitive and often regulated environment that is subject to rapid change, but boards of directors have to look to creating a long-term sustainable business. To achieve this, the shareholders of a company will need to have top quality, carefully selected directors as their representatives on the board.

Based on agreed pre-determined 'person specifications' prepared by their nomination committee, boards should widen the pool of non-executive directors from the current perceptions of the status-quo by openly giving consideration to potential candidates from:

- individuals who are currently below board level in other companies; and
- individuals from other relevant walks of life.

Whatever the role or background of a director, executive or non-executive, all must understand how business works, have relevant and management experience and be able to demonstrate independence of mind/thought as a top priority.

Top quality people who are currently below board level in (say) the FTSE 350 companies are obvious candidates. There may be practical issues such as would a board be willing to accept someone who is not already on the board of his/her own organisation, or would the individual be released to spend time with another company? Nevertheless, this option should be considered. Helping individuals to obtain their first post as a non-executive director in another company could be useful for both parties.

Widening the pool to find individuals best qualified for the job should also include consideration of people from the accountancy and legal professions and the financial sector (e.g. fund managers, corporate finance and banking) and from other walks of life. Government, the not-for-profit sector, and academia should also be able to produce valuable candidates who can translate their management and other skills into a commercial environment. Appropriate training courses may be helpful here.

All directors, be they current or future appointments, should be able to make an effective contribution to board level discussions and help to create a sustainable and competitive advantage for the company. If they are unable to do so, then they should not be on the board.

3. Liability of non-executive directors

Recent events, rising expectations and, in particular, the writs against all the former directors of Equitable Life have highlighted the potential liabilities of non-executive directors over and above the risks to their personal reputation. Directors & Officers insurance is now expensive and the level of cover has decreased. The risk/reward balance is now a major issue and consideration must be given to the creation of a sensible link between the two sides of the risk/reward equation. Without a pragmatic solution to the uncertainty over liability, there will be future problems in retaining, let alone recruiting, the best and experienced individuals that are needed by UK plcs, particularly for the larger listed companies.

We support the view of the Company Law Review that does not seek to distinguish between the legal duties of executive and non-executive directors as this might undermine the unitary board concept. However, and whilst we appreciate that director liability is a very complex area, as part of the current review of matters related to the Company Law White Paper consideration must be given to the development of some basis for protection for non-executive directors on liability matters. Development of “best practice” guidance might be a means by which a benchmark could be set.

Consideration might be given to proportional liability as well as capping liability by way of contract, whilst ensuring that this does not also undermine the unitary board concept. This would apply to all directors and, in particular for the non-executive directors, it should be linked to what an individual would reasonably be expected to know. It needs to be recognised that the non-executive director can never be as knowledgeable about a company as an executive director. Non-executive directors have, and are entitled to, rely (after due and careful enquiry) on the information provided to them by executive directors, senior management and other advisers.

The advantage of proportional liability (over the current joint and several liability) is that the quantum assigned to individual directors (and in particular the non-executives) is reduced and they are not expected to contribute to the losses awarded against rogue CEOs. As mentioned at the outset, the billion pound litigation against all the former directors of Equitable Life indicates that the current system of joint and several liability will increasingly become an impediment to selecting and retaining the best individuals.

4. Developments in the US and the unitary board

Recent developments in the USA (some of which have been hastily introduced such as the Sarbanes-Oxley Act) prescribe a legally based, rules-driven approach to their corporate governance framework. Whilst this may be viewed with favour in the USA, in the UK, we have different traditions and, put simply, we do things differently. Our model of corporate governance, based around the well considered principles laid down by the Cadbury Code of Best Practice and followed up by the Combined Code, is well respected. We see no reason to fundamentally change our system to something akin to that used in the USA.

The unitary board has served the UK well. As the single governing body, the members of the board of directors, all of whom are appointed by shareholders, should receive the same board papers thus allowing them to participate (on the basis of the same information) in the decision-making process. This gives the non-executive directors a better chance of getting to the core of the company than might be the case in a two-tier system (used in some continental European countries) or in an alternative unitary board model so often found in the USA. In these other models, it may be easier for a dishonest management team to withhold information from all the directors.

In the US model there are considerably more non-executives than executives on the board. Often this will mean that there is only one, sometimes two, executive director(s) (the CEO and possibly the CFO) on the board, and US boards often combine the role of Chairman with that of the CEO. There are problems with this model such as the concentration of decision making power that this puts into the hands of one individual.

Power in the hands of a ‘maverick’ CEO can result in many problems even though there are many good non-executive directors on the board. For example, with only the CEO on the board, will the non-executive directors be fully apprised of all the relevant information to enable them to get to the core of the business without the involvement of some of the other executive directors? Following the Maxwell scandal and others over a decade ago, the Cadbury Code introduced the principle of splitting the role to provide checks and balances. It was kept in the Combined Code and we see no reason to change the UK approach.

5. Audit committees

Reporting to shareholders by the audit committee on the appointment or removal of auditors, audit fees, auditor independence and quality and the approval of non-audit services are issues that, to varying degrees, form part of the output of recent reviews in the UK, the USA and elsewhere. These matters, in combination with their work relating to the review and agreement of accounting policies, financial reporting processes, the truth and fairness of the financial statements, as well as matters to do with internal control, and a need to understand the nature of transactions the company is entering into, will bring substantially increased expectations of the members of the audit committee. It will be necessary to ensure that members of the audit committee have the specific skills and expertise for the changed role that is now envisaged.

These changes will have at least two implications: (a) a possible strengthening of the membership of the audit committee and (b) training and updating. To strengthen the membership of the audit committee will require some guidance on the attributes needed for the chairman and members of the committee. Whilst financial literacy and knowledge of the role of the audit committee in corporate governance are basic requirements for all members of an audit committee, at a minimum the chairman (and preferably others) on the committee will need to have a good grasp of accounting and auditing issues. Training and updating will therefore be of considerable importance specifically to the chairman but also to the other members of the committee.

Members of an audit committee will be assuming very significant responsibilities on behalf of shareholders. Care will have to be taken that they are not overloaded and that audit committee undertakes its work within the unitary board system.

6. The development of guidance

In a similar manner to the approach adopted by the Turnbull report, the key to any suggested guidance is to define what the best companies do best and, whilst mindful of resource constraints, encourage others to follow. With sufficient disclosure, eventually good practices are likely to become common practices.

The Higgs' Review Team may wish to provide a general framework and guidance for non-executive directors. This could include:

- Role and duties
- Time availability and length of service
- Remuneration

There may be additional categories, but some initial suggestions on the above are:

A. Role and duties

Guidance on the role and duties of different directors such as:

- The Chairman;
- Members of the audit, remuneration and the nomination committees;
- The non-executive directors (in general); and
- The CEO and other executive directors.

Reference should be made to the number of board meetings in a year. This is a key issue for the direction and control of a company and especially for the non-executive directors to keep up to date.

B. Time availability and length of service

A key issue for the board and the individual(s) concerned will be time available to commit to the company, which is very likely to increase if a company gets into trouble. We make some suggestion on the issue of time commitment in our answers to Question 6 in Appendix B.

With the exception of the role of a chairman (of the board and of a board committee), the Review Team might give consideration to the proposition that (to avoid a threat of familiarity) after a period of two terms of three years, non-executive directors should justify why they consider that they remain independent. This may also help with board succession planning.

C. Remuneration

There has been some debate on the nature of remuneration for non-executive directors. On balance we believe that non-executive directors should be remunerated by way of a fee package that is a mixture of shares and a salary/fee, and that they should not receive share options.

As an alternative to a set annual fee package, consideration could be given to paying a smaller 'retention fee' and a sum for each board and committee meeting attended.

7. Way forward on the Combined Code

There are areas of the Combined Code that could be updated to take account of recent developments. These surround the reporting to shareholders in the company's annual report on matters that the audit committee have reported upon to the board. They include:

- auditor appointment and removal
- auditor remuneration
- auditor independence
- non-audit services

Consideration could be given to a requirement that the audit committee's charter (terms of reference) should be published on the company's website and kept up to date.

Our initial suggestions on other matters on the Combined Code are as follows:

Information on the backgrounds of all directors

Annual reports could contain more comprehensive information on all board members such as their background, previous management or professional experience, and their professional qualifications. On appointment, there could be some information about the reasons why a particular person has been appointed to the board. This will allow

investors to get better information and to judge the quality and the suitability of the directors.

Training and updating for non-executive directors

Increased emphasis should be placed on Code provision A.1.6. All the non-executive directors, especially those who sit on board committee that deal with technical issues such as the audit committee, need to be sufficiently trained and kept up to date.

Consultation on any proposed changes to the Code

Any changes to the Code should be based around the flexibility and practicality that is brought by more disclosure rather than more rules.

We also suggest that any proposed changes are widely consulted upon before being finalised.

We would be pleased to offer further comments to the Higgs' Review Team on these or other matters if so requested.