

Response to the Higgs Review Consultation Document From Jane E Tozer

A: Rôle. What rôle should non-executive directors perform, and how does this compare to the present position?

1. What is the rôle of the board? What is the rôle of the Chairman and how does it relate to the non-executive directors?

The Board's rôle is to

- recruit, appoint, motivate and review the executive team
- set the strategy and business plans for the company,
- assess the risks and opportunities facing the company,
- ensure that the strategy and plans address them,
- monitor the quality of their execution and the effectiveness of the executive management,
- and ensure that good corporate governance is maintained on behalf of the shareholders.
- ensure succession planning for the top team

The Chairman's rôle is also to

- personally counsel, motivate and review the performance of the CEO
- set the agenda of the Board,
- ensure all directors work together effectively as a team,
- and to ensure that the Board continuously develops its skills and effectiveness through appropriate training and reviews.

The training and review process is important for both executive directors and non-executive directors, should include training in the responsibilities of a public company director, and for non-executives should include the provision of an induction programme.

2. What should be the key rôles of non-executive directors on the board and what should be the balance between the different components? Within a board, should all non-executive directors be expected to fulfil each of the different rôles?

The key rôles of the non-executive directors are to

- help set the strategy and business plans for the company,
- assess the risks and opportunities facing the company
- ensure that the strategy and plans address them,
- monitor the quality of their execution and the effectiveness of the executive management,
- and ensure that good corporate governance is maintained on behalf of the shareholders.

All of these components are vitally important, and all non-executives must contribute to all of them. For example, it is not acceptable for a non-executive director to assume that the other non-executive directors are assessing the risks, or evaluating executive director performance, and therefore to abandon their own personal responsibility to carry out these functions.

However just as the executives have and are selected for different skills, the best non-executive teams reflect a range of skills. There is a danger that the growing focus on and increasingly onerous nature of the governance aspects will unduly dominate the non-executive rôle in future. This will dilute the major contribution that non-executives can make to the first three items above. The more that legislation or regulation asks the non-executive to be a policeman, the less will be their contribution to these strategic and business items.

3. How does this compare to the present position?

In my experience these are the functions currently being carried out, though the risk review element has only recently been added. The corporate governance and monitoring of executive management performance could sometimes be done better. The induction process and the continuous review and development of the Board's own performance could in most cases be done better.

4. How independent do non-executive directors need to be for the different rôles?

My suggested definition of Independence is as follows:

- Not a significant supplier or advisor to the company, or an employee of same. It is ok if the person carried out a relatively brief consultancy assignment before being appointed – this might be how both sides decided that they would be a good person to add to the board. However it is not ok for the non-executive to receive large consultancy ‘retainers’ in addition to their fees, once appointed. Small consultancy fees for specific projects carried out with the full knowledge of all of the Board are ok, so long as they do not dominate the financial relationship.
- Not a recent owner, executive director or senior manager of the company. 3 years??
- Not an option holder or substantial shareholder, by which I mean substantial enough to act in their own interests rather than that of the shareholders as a whole.

I would like anyone who does not meet these criteria to be called an Outside Director, so that the shareholders know what they are dealing with – who is truly independent and who is not.

5. What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a rôle in protecting the interests of the company? What can be done to help non-executive directors to be effective in relation to these conflicts?

The main conflicts are in revenue recognition policies, cost recognition policies, executive management recruitment and remuneration, supplier and partner selection, and merger and acquisition transactions.

Non-executive directors should protect the interests of the company by evaluating these things from a truly independent point of view, unaffected by their own remuneration or shareholdings.

Non-executives should have access to independent legal advice, as of right, to help them in this role, and should have the right to appoint and change the auditors. In addition, we need clear Best Practice guidance on the issue, and to ensure that the sanctions if they fail to do so are clear and serious. See attached article on “The Trends and Challenges Facing Non-Executive Directors”, in Appendix A.

However it is a mistake to expect a non executive director to provide a guarantee that errors will not happen, or that deliberate inappropriate action cannot be taken (and hidden). This would never be possible, no matter how much time they spent with the company.

6. What time commitment is needed for the rôle of Chairman and for non-executive director rôles, and how far does this vary between different companies? Are there any implications for the number of non-executive posts that one person can sensibly take on?

For companies who have monthly Board meetings, the non-executive director should allow 20-25 days commitment in a ‘normal’ year, and this will rise in a year when either a transaction takes place (merger, acquisition, fund raising, etc) or where the business hits particular problems. The Chairman should allow about 45-50 days per year. These numbers are substantiated in a survey of non-executives in the TMT sector carried out by ITNEA in 1999. The time commitment will if anything have increased since the survey was carried out. One of the issues today is that while these numbers are what is needed for directors taking their rôles seriously, many companies suggest during the appointment process that a lot less time is needed, and pay accordingly.

For companies that meet less frequently (eg Investment Trusts which meet only quarterly plus AGM etc) the time commitment will be reduced accordingly – typically 12-15 days a year for the non-executive director of an Investment Trust.

There is a limit to the number of non-executive posts that any one person can take on, but it depends on the following factors as well as the points above:

- some people have a private support office and some do not.

- some people will be appointed to a holding company board and a number of subsidiary boards in the same group. The subsidiary boards may well never formally meet in this case, as their business is dealt with in the holding company board meetings. So what can look like six appointments might only be one in real workload terms.
- some companies are not actively trading (cash shells etc).

For this reason, I believe that guidance in the form of a fixed maximum number of appointments will do a lot more harm than good. The guidance must be a realistic assessment of the time needed, and that each person and the appointing company must satisfy themselves that the prospective director really can provide enough time to do justice to the job, both in good times **and in difficult times**.

7. Should there be a special rôle for a “senior independent” non-executive director?

Yes, in terms of someone nominated for the other directors or the shareholders to go to if they have issues with the Chairman’s performance. But I’m not convinced it needs a lot of extra time in the normal course of events, unless the role is recognised by the institutional shareholders. In this case the Senior non-executive director should perhaps attend company meetings with them, and the extra load would be comparable to chairing a board sub-committee.

8. Do you have comments on the proposed statutory statement of directors’ duties, which does not seek to distinguish between the legal duties of executive and non-executive directors?

There should be no distinction between the legal duties of executive and non-executive directors. To draw such a distinction would destroy the unitary board, which is a major asset in the effective performance of Boards in the UK. It would produce a huge Them and Us divide, as happens with the German Supervisory Boards, and would destroy effective communication between the executive and non-executive directors.

However, non-executive **liability** should be seen in the light of how much the non-executives can reasonably be expected to know, given that they are not there every day. Also, if the executive directors have deliberately withheld key information or not answered questions fully, there should be a very strong difference in liability. But it must be clear that the non-executives made all reasonable enquiries, otherwise this could encourage them not to carry out their job diligently.

B: 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 rôles?

9. What are the key skills, knowledge and experience which are needed by non-executive directors to perform the rôle effectively, and how is this likely to change over the next, say, 10 years? Are some skills essential and, if so, what are they?

Knowledge & experience: Real experience of running a business, plus good knowledge of the Combined Code, Best Practice, company and employment law etc

Skills: Strategic thinking, diplomacy, numeracy, salesmanship, ability to absorb large amounts of information quickly, inter-personal skills.

I think all of these skills are essential, but if I have to single any out it would be strategy, numeracy and the ability to absorb large amounts of information quickly. Without these, the non-executive director is unable to carry out the monitoring and corporate governance rôles on behalf of the shareholders. **If they can’t carry out those rôles they should be an advisor or consultant to the company, not a director.**

10. What personal qualities and attributes are needed?

Integrity, total trustworthiness, independence, decisiveness, eye for detail, ability to weigh risk - reward (not too gung ho or risk averse), and genuinely enough time available to do the job properly.

11. What sort of mix of experience and attributes is desirable on a Board? Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.

The whole board needs to have the **real business management experience** and the personal qualities and attributes described above, otherwise some members will drop out of some discussions and decisions, leaving it to the others. This is divisive and dangerous, as it can lead to many decisions being taken by 'the experts' in that area, and destroy the value of the unitary board bringing a range of relevant experience to the direction and control of the company.

The business management experience needs to cover, between them, all aspects of the business: strategy, sales, marketing, finance, HR, legal, research, development, distribution, etc as appropriate to the business in question.

12. How easy is it to recruit non-executive directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?

There is a perception on many boards, especially in the FTSE, that the best sources of non-executives are a CEO from another similar sized company or a Big Name. This perception is actively encouraged by the head-hunters, not least because it makes their job so easy if they are appointed to do a search – it gives them a very small and focused group to target.

The CEO and Big Name Club has replaced the Golf Club as the preferred method of sourcing non-executive directors!

There are 2 problems with the CEO Club method of appointment:

- these people do not have the time to do the job properly. They can do it if all is smooth running in both their own and the non-executive company. But if either side has a peak workload (a transaction, fund raising, business problems etc) then it just doesn't work. The CEO has to give his or her time first and foremost to their own company, and the non-executive company gets short shrift. I have heard of this problem time and time again from many chairmen and CEOs over the last few years.
- These people **are not independent**, especially when it comes to Remuneration committees. The FT has published statistics on the relative growth in executive directors' pay vs everyone else's pay over the last 10 years, and the results are shocking. They derive quite largely, I believe, from the CEO non-executive Club in operation.

The Big Names method also has problems: many take on the job, often many times over, and **don't do it properly**. They are often there for the kudos and leverage they bring to the company, not for the work they are actually going to do. (See Appendix B, FT article, August 12th 2002.)

The perceived shortage of good candidates for non-executive positions derives from this blinkered thinking, that CEOs and Big Names are the best sources. I believe that companies can address this shortage by making better use of the large pool of portfolio directors, who are usually people who were CEOs or executive directors in the recent past, with no need to resort to people who have no experience of actually running a business. I know this is a self-interested point, but I also happen to believe strongly that it is true!

There is not a problem in attracting such people to do the job, at the moment. In my rôle with the Information and TMT Non-Executives' Association (ITNEA) I get lots of very able people asking if I can help them find non-executive jobs. We need companies to stop preferring the CEO club and Big Names above all other candidates, widening the pool they draw on as above, and the CEOs and Big Names to stop taking on more than they can ever do justice to!

There is however a risk that if the legislative and regulatory burden of being a non-executive director increases, the pool of people willing to do the job will shrink dramatically. I know of a handful of people who have decided that the risk reward ratio is no longer worth it. This is partly caused by the modest fees and partly by the increasing liabilities, especially in public companies.

13. What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?

There has been much talk of widening the pool of people from which non-executives are drawn. Good idea, but please make sure that it is a wider pool of people with the knowledge and experience that comes from actually running a business, as covered above.

By all means use advisory boards etc to consult with customers, civil servants, academics and so on in developing the business and its plans, but **stick to experienced train drivers when it comes to driving the train!**

The civil servants, academics and customers have a lot to add, but it is unfair and unreasonable to them, and to the shareholders, to ask that they take on the responsibilities and corporate governance duties that go with being an effective non-executive director unless they also have real experience of having been an executive director. To do so will be to seriously weaken the quality of corporate governance that is applied.

14. Are the rewards for non-executive directors appropriate, both in terms of levels of pay and the form that remuneration takes – e.g. cash/shares/share options? Are current pay levels a significant factor in whether good non-executive directors can be attracted?

The current levels of pay are high enough for the larger listed companies, but too low for the medium and smaller ones. The bigger ones pay more, but the job is the same. Unlike the CEO's rôle, where company size is a factor, I believe the non-executive's rôle and responsibilities for public companies are largely size independent. If anything, the non-executives of smaller companies may well put in more time than on the larger ones.

For private and VC backed companies the rate can also be too low, but everyone who goes into it does so with their eyes open. Sometimes the VCs encourage the companies to pay too little. Many of the risks are the same as with the public companies.

We should pay the proper rate for the job, rather than the current low rates. But if the pay is all we fix then all that will happen is the Big Names will get more money for less time!

With regard to payment in options, for a listed company: No! This gives them an incentive to acquiesce to aggressive revenue recognition policies or questionable cost allocation decisions. The shareholders need **someone** who is genuinely impartial to look at the policies and practices before the numbers get to the Auditors, and the Auditors need someone on the inside who can take a genuinely independent and unbiased view if and when they challenge or recommend changes to the executives' views. If non-executives are ever to be given options, they should be vested (so that they are not lost if the non-executive decides to resign on a point of principle) and the shares should not be able to be sold in the medium term.

With regard to payment in shares, for a listed company: also No! This is a throwback to the view that only the rich can be trusted to have integrity. Why are we so anxious not to pay a fair rate for the job? Paying in shares hits the P&L just the same as cash, but gives the non-executives an incentive to manipulate the share price, at worst, or acquiesce to aggressive accounting at best.

Paying in shares is claimed to align the directors' interests with that of the shareholders, but their interests are not the same! The non-executive directors' job is to make sure the share price is **fair**, not to force it inexorably upwards (unless justified). There are 2 ways to make a share price go up – the fair way and the wrong way. Unfortunately, as we have recently seen, if the fair way doesn't work, performance linked motivation will make some people choose the wrong way.

If a non-executive wants shares in the company they can buy them in the open market with their fees. I don't believe in banning it, unless they buy so much as to compromise their independence (see above). They should be as free as any other director to buy a small stake in a public company.

If Corporate Governance matters, which it does, then we should pay the fair price for getting it done effectively, in cash, just like we do for all other services. We should then

expect a professional and committed job to be done in return. Imagine the outcry about conflicts of interest if we paid the Auditors in shares!

15. Do you have comments on the issue of risks or insurance provision for non-executive directors?

The risks the non-executive director faces are identical to those faced by executive directors, yet the non-executive may have been deliberately misled by the executives. This is of course also true of the executive directors – they may have been misled by an executive colleague – but it is much easier to mislead someone who is not there every day. Effective D&O insurance is therefore not only desirable, but necessary if we want to have a large pool of good non-executives to draw on. But D&O insurance is getting hard to find, very expensive, and hedged with huge amounts of disclaimers. The private sector does not seem to want to provide this cover any longer. Since the DTI already has a rôle to investigate and act on directors' wrongdoing in the event of trouble, maybe there should be a government backed D&O insurance scheme?

C: Structures and accountability. Do existing structures and procedures facilitate effective performance by non-executive directors?

16. How is the Combined Code working in practice? In particular, how are the provisions on the balance between executive and non-executive directors and the rôle of independent non-executive directors working? Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?

Overall I think the Combined Code is working very well. There has been a noticeable improvement in the corporate governance applied to UK companies in recent years, and the openness of reporting to shareholders. The rôle of the non-executive director is becoming better understood and respected, and the old days of the golf club chum who just comes for the lunch are dying out, but not yet fast enough.

The definition of Independence should be clarified in the Combined Code (see Q4 above).

17. Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors? Are board meeting procedures working effectively? Do you have comments on board size?

Yes, the board committees do facilitate governance and effective contributions from the non-executives, so long as the CEO and other executive directors have a clear understanding of the requirements of corporate governance and an openness and willingness to benefit from them. The CEO usually sets the tone here, and if they are defensive and not open with their non-executives, then corporate governance breaks down no matter how hard the non-executives try.

Large boards (say more than 12 members) are very difficult to manage effectively. Once the group gets to this size, several people are likely to say little or nothing throughout the entire meeting. This is divisive, inhibits contributions, and creates a tendency for an inner 'elite' to decide board matters in advance, using the Board meeting merely as a rubber stamping exercise.

18. Do you have comments on the composition and duties of Audit Committees? How effectively are Audit Committees working in practice? Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?

I believe Audit Committees are effective in practice, so long as the members have the attributes needed (independence, integrity, numeracy, attention to detail, ability to absorb large amounts of information), and so long as the non-executives spend enough time on them. This can be a real problem if the non-executive is from the CEO Club, especially if their own company is going through a peak workload or business problems at the time.

19. Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?

My comments are the same, with the added problem that I do not believe the CEO Club non-executive director is a suitable member of a Remuneration Committee. They have a vested interest in the mantra that we must pay globalised (ie USA) packages for CEOs, and in the

winding up of the norms for options, LTIPs and other performance related reward schemes. In the event of termination of an executive director, they also have a vested interest in paying possible over generous severance packages.

Note that I am not suggesting these vested interests are cynically and deliberately applied. I have no doubt that in almost all cases the 'CEO' non-executives act in good faith, but a person who is still regularly and passionately negotiating his or her own best terms in one company is inevitably going to be very sympathetic, perhaps overly so, to the same arguments used by the executive directors of the company of which they are a non-executive director.

20. What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?

The business plan and performance against it are the most obvious objectives against which all boards measure themselves. In many companies nothing more is done by way of performance objectives and review. I think it would be good Best Practice for boards to have a brief annual review, set themselves some targets in addition to the business plan (both as a group and for individual members), and to evaluate progress against these targets as part of the next year's review. This process should be initiated and led by the Chairman.

21. Could more be done to review performance? Should more information on board performance be reported to shareholders? Should companies provide more information on the performance of non-executive directors?

More could be done to review performance, as above, but this should not be explicitly reported to shareholders. We report the performance of the company to shareholders, not the private discussions that take place between board members. We don't publish the private discussions the Chairman has with the CEO over performance, merely the result of it in terms of the rewards the CEO receives. Similarly we don't publish the private discussions the CEO has with their reporting executive directors. To publish this information, or the equivalent information on non-executive directors, is to guarantee a sharp drop in the number of people willing to take on the rôle. There is a limit to the amount of self-flagellation we need to do in public!

22. Are non-executive directors able successfully to challenge executive decisions or expose serious problems? Should it be made easier for them to do so and, if so, how?

With an open and receptive CEO, yes. With a defensive CEO who does not value the non-executive directors, no. This is more likely to be the case if the CEO is also the Chairman, or in a private company where the CEO has a substantial, maybe majority, shareholding.

It would be made easier if there were a clear Best Practice definition of the rôle of a non-executive director, and if senior management and executive director training programmes spent more time educating the executive team in the value they should seek from their non-executives. A good CEO should welcome challenge and help in uncovering problems.

D: Relationships with shareholders and others. Do existing relationships with shareholders or others need to be strengthened?

23. How well do relationships between non-executive directors and shareholders and stakeholders work, and could they be improved? For example, we would be interested to hear views on what the relationship might be between non-executive directors and institutional shareholders. How could this relationship be strengthened?

Institutional investors do not in general want to be 'active' in questions of company management. They see their job as supporting the company if they like it as an investment, and selling the shares if they don't. Equally, I don't think they should become more 'active' – they have almost without exception never run a company and it is a lot easier to snipe from the sidelines than it is to actually do the job!

As a result, I don't support mandated contact between non-executives and institutional investors. However, I would like the institutions to be more willing to call on the non-executives if they have

concerns, rather than leaping straight to the Sell decision. Maybe there should also be an offer of an annual brief discussion, along the lines of the non-executives' discussions with the Auditors.

24. To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more that they could do, by promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows, or otherwise?

Chairmen have a key rôle in creating the conditions for non-executives to be effective. They can and should do all the things mentioned in the question, together with an annual board performance review as described above. Chairmen should take responsibility for the effective development of the Board as a team, just as the CEO takes responsibility for the effective development of the management team. This includes how they work together as a group, their education (individually and as a group), their personal objectives, and their performance overall.

If non-executives feel unable to or inhibited from challenging and contributing in board meetings, or if they are not getting the right information, then either they are the wrong person for the job or the Chairman is doing a bad job, or quite likely both! Whatever the reason, the Chairman needs to take action to sort it out.

25. What should be the relationship between non-executive directors and executive directors, and with senior management? What should their relationship be with the Chairman and the Chief Executive? What should their relationship be with key advisers to the company?

Open, honest, robust, direct, apolitical, constructive, focused on the interests of the shareholders. In all cases.

26. How can Company Secretaries support effective performance by non-executive directors?

- Ensure that they have all the information they need on a timely basis.
- Ensure that all board discussions are accurately minuted.
- Check that agreed actions are followed up and carried out.
- Ensure all the required company reporting is done accurately and on time.
- Ensure D&O and other insurance policies meet the needs of the company and are maintained at all times.
- Assist the Chairman in drawing up the annual schedule of matters to be considered at board meetings.
- Monitor the Board's compliance with the Combined Code and alert the Board when action is required.
- Monitor the Board's compliance with other matters (eg ABI or other guidelines) and alert the Board if discussions or actions are needed.

E: Support. How can non-executive directors best be supported to perform their rôle?

27. How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?

A non-executive should draw up their own checklist of the information they need on a regular basis, which will vary from company to company. They should request that this information is covered in the company's regular reporting to all directors, and work with the executive management to achieve this if it is not already in place when they join the Board.

In practice, information flows and communication channels vary hugely from one company to the next. As stated above and in the article in Appendix A, I believe the CEO's attitude is crucial in establishing sufficiently open and unrestricted communication with the non-executive directors. We should train all CEOs and Chairmen to be more open and willing to listen and learn from their non-executives. Make it clear Good Practice that a good CEO does this, rather than regarding them as a nuisance to be fed only what they need in order to keep the ravenous Corporate Governance beast at bay! This is even more important if the CEO is also Chairman.

Last but not least, non-executives need to take the rôle seriously and to give it enough time, not seeing it as a trophy or a personal development opportunity (back to the CEO Club points!)

28. What training and development opportunities are available? Could they be improved and, if so, how?

I have sought out training opportunities for myself, rather than any company providing them for me (except when I provided them for myself and my team, when I was a CEO).

Training is available at the IoD and at 3i IDP events, plus various conferences, seminars, and reading around the subject.

29. Can induction for non-executive directors be improved?

Yes, definitely. Big companies tend to do it formally, and probably quite well. Medium and small companies tend not to do it!

30. Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?

No – in my experience they often have to work it out for themselves.

F: Smaller listed companies. In what ways is the position different for smaller listed companies?

31. To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?

I'm not in favour of making distinctions for smaller listed companies. They usually do not achieve the simplification and reduction of the burden that is their objective (you only have to look at the AIM rules to see this – they are in some ways more burdensome than the main market!)

However, I do think that the implementation of Best Practice and the Combined Code should be viewed with an understanding of the size of the company concerned. Auditors and advisors are not good at doing this, which is hardly surprising since it is in their interests to make sure everyone does as much as possible, usually with their paid help. We need to be able to accept a more pragmatic implementation of the rules and Best Practice where it is appropriate.

G: International context. What can we learn from international experience?

32. What lessons can be learnt from international experience, either in terms of structures or behaviours?

I have not been a director of companies listed overseas, though I do have some experience of the German system of Supervisory Boards and the US system of public company boards. In my view the UK system is streets ahead of both!

The German Supervisory Boards are very remote from the operation of the company, are often staffed by family, advisors and friends, and provide much less effective monitoring or company performance or protection for the shareholders. They pay peanuts and they often get monkeys.

The US boards are also more remote from the company, since they typically have only one or two executive directors on them. The rest of the board is often made up of CEOs from key customers or suppliers, and members of the industry CEO club. The results, deriving from conflicts of interest, greed, and a lack of real information and effective monitoring by the non-executives have been disastrous for shareholders and employees, as we have seen in the last year.

33. Do other models of corporate governance or different boardroom rôles or dynamics contribute more to company performance?

The US system contributed more to *apparent* company performance, but it was a chimera. So my answer is no!

34. Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?

Not in my (limited) experience. Our Principles based approach is the right one, we just need to make sure people have the time to apply the principles effectively, not to drown them in a lot of detailed rules and regulations.

As is covered in the article in Appendix A, there is no better example of this than the different approaches to accounting in the UK and the US. In the UK all directors are obliged to ensure that the company's report and accounts are a true and fair view of the company's operations so that the shareholders are not misled or duped. This puts a legal and moral obligation on directors to make sure that the accounts really do reflect reality. In the US there is no such duty, as spectacularly illustrated by Enron. There, the rules try to anticipate every possible trick that the directors could get up to in the report and accounts, and then forbid it. This has spawned a vast industry whereby lawyers and accountants try to find legal ways around the detailed rules that nevertheless flatter the company's results. The result, amongst others, is the Enron Special Purpose Vehicles which allowed assets and liabilities to vanish from all public company balance sheets just because 3% or more was held by a private company. This simply could not happen under UK accounting rules. It was perfectly legal in the US, though it may not remain so for long.

Micro-management does not lead to trustworthy behaviour, it leads to clever handling of the micro-management rules. A clear statement of the legal and moral obligations **in principle** provides a much better framework for trustworthy behaviour. It does not guarantee it, but at least it lays down what is expected; then defining breaches and punishments is easier and more likely to be effective.

Personal Summary

In summary, the things I would most like to see coming out of this Review are:

- Strong Best Practice guidance against the CEO and Big Names Club method of appointment! Provide clear guidance to companies that a non-executive appointment of another CEO or a Big Name is not the way to do it, **they will not have the time to do the job properly**. If the company wants to get kudos, influence, contacts or whatever else from the Big Name, do it by some other means!
- Use the much larger pool of people with real business experience, not the academics, civil servants, community representatives etc. **Get experienced Train Drivers to drive the trains, and ones who have enough time to read the signals!** (substitute airline pilots, surgeons, teachers or whatever other analogy you prefer)
- Strong Best Practice guidance against share options for non-executives of public companies. Options are fine in VC backed and other private companies, where a non-executive director has a very different rôle.
- Make it clear that the non-executive director's rôle is **a real job**, not a sinecure that might as well be used to achieve other benefits along the way. This means making it clear to non-executives that their business experience is valued, and it is **what the government expects them to put into practice** to help their companies and their shareholders. Just turning up once a month is not enough. It also means making it clear to the companies that they should pay the fair rate for the job, and then be open and make effective use of the business experience available to them from their non-executives.
- Finally, we must not focus so much on corporate governance that the other part of the non-executive's role - that of helping the business to grow successfully - is lost!

Appendix A

Trends And Challenges Facing Non-Executive Directors of Public Companies

If you are a non-executive director of a public company you could be forgiven for thinking that Confucius's curse has finally been visited on us: we do indeed live in "interesting times". A whole panoply of events in the last few months have thrown the spotlight on the non-executive director to an unprecedented extent:

- How much did the non-executives at Enron know about the accounting treatments being used? And how much **should** they have known to be doing their job properly?
- Are the past non-executives from Equitable Life rightly liable for the losses incurred when they decided as a board (no doubt in good faith and after copious advice) that they could remove the guarantees of the Guaranteed Annuity policies?
- Why were the non-executives at Marconi not even asked if they could move the board meeting to an earlier time last year, to avoid the disastrous suspension of the shares?
- Walter Hewlett says "Dissent is not disloyalty. Healthy boards need not agree on every issue". Fair enough, but do you expect to get a lawsuit when one of your fellow non-executives disagrees with the majority decision?
- It is common for US stockholders to sue the company and its officers when the share price drops, on the basis that you must have known it was going to happen and **someone** has to be to blame for their losses.
- Is Lord Young right that non-executives can never know enough in order to fulfil their obligations, and are therefore a waste of time?

Will Derek Higgs' review of the rôle either agree with Lord Young and recommend abolishing us, or react to the recent problems with a truck-load of extra rules and compliance requirements?

In the context of all these questions it is not surprising that we are beginning to hear stories of companies finding it very difficult to recruit non-executive directors (especially in the US), and of individuals deciding it is not worth the risks any more, and resigning their portfolio of directorships en masse. **Is the job worth the candle?**

I will discuss the issues under 4 headings:

1. Trust and Information Flow
2. Compliance Rules and Best Practice
3. Liability
4. Reward

1. Trust and Information Flow

As Lord Young has pointed out, it is very hard for a non-executive director to know what is really going on in a company. Unlike the executive directors who are there everyday, the non-executive has only intermittent contact. The non-executive therefore puts a tremendous amount of trust in their executive colleagues to tell them what they need to know about the company news, good **and** bad. To a degree there is nothing new in this. Executive directors also put a tremendous amount of trust in each other – the determined fraudster will hide information from their colleagues, exec and non-exec alike. However I do think the issue is in sharper focus for the non-executive, because they have so much less opportunity to find things out naturally, by just being there.

The non-executive therefore has to do two things:

- a) **Choose your companies carefully!** Some executive directors see non-executives as a valuable source of experience, wisdom and advice. These people will tell their non-

executives the good news and the bad, in order to have meaningful discussions and get full value from the experience and advice on offer. Other executive directors see the non-executives as an expensive burden that they are obliged to have: a waste of space. These directors will tell you only what they need to in order to get your agreement or to be seen to comply with the rules. Bad news will be saved for when the company is in big trouble, and it is no defence or reduction in your legal responsibilities to say “I didn’t know!”

In my experience, the CEO’s attitude is a vital determinant in establishing the behaviour of the rest of the executive directors towards the non-executive directors.

- b) **Put in the time needed!** I have no sympathy for a non-executive who is ill-informed about the company and its true situation if all they do is turn up for the lunch and the board meeting once a month. To deliver value for your fees needs more effort than this, and should include regular contact between board meetings whether in person, by telephone, by email, or more likely all three.

The non-executive should be willing to participate in the executive management’s discussions and meetings, if invited, and in any event should ask enough questions to demonstrate that they have tried hard to ensure that they know enough to do their job properly. This includes both aspects of the job: the corporate governance rôle and the ‘team member’ rôle of adding your experience and judgement into the Board team in order to help the company reach its full potential.

The other aspect of trust is the shareholders’ trust in the Board to treat them fairly and enable them to assess the company’s true situation. In many aspects of life we seem to be undergoing a ‘crisis of trust’, so much so that this was the title of the 2002 Reith Lectures by Onora O’Neill. The papers tell us no-one is trustworthy; not the government, our teachers, our health professionals and certainly not businessmen. Ms O’Neill’s conclusion is that addressing the issue should be less about seeking accountability through micro-management and central control, and more about promoting good governance and communicating in ways that are open to assessment. She talks of the need to create a robust public culture that recognises both the need for trust and the duties and responsibilities (on both sides) that go with it, rather than using ever more detailed rules to tie people down until they behave rightly – this hasn’t worked in the past and it won’t work in the future.

A board that operates on a basis of openness and trust, combining good exec/non-exec director communication with non-executive diligence and effort, should provide effective protection for the shareholders *and* the non-executives.

2. Compliance Rules and Best Practice

Do we need to extend the Combined Code in the light of recent events? Personally I think we should think long and hard before doing so. I don’t want to be complacent and I’m sure the Code can be improved, but it is far easier to add to the Code and produce an over-bureaucratic and burdensome process than it is to streamline it afterwards.

A recent PWC survey of international corporate governance shows that we have a world-leading code of practice in the UK. We are more open, have safeguards to ensure that our non-executives are more truly independent, and have more stringent responsibilities and penalties in place than is the case in much of the rest of the world. That is not to say we are perfect and scandal free – clearly this is not the case – but the solution to a scandal is not to try and anticipate every possible set of circumstances and prevent it. Rather the solution is to ensure that the obligation to act legally, fairly and in the shareholders’ interests is crystal clear and appropriately penalised if not implemented.

There is no better example of this than the different approaches to accounting in the UK and the US. In the UK all directors are obliged to ensure that the company’s report and accounts are a true and fair

view of the company's operations so that the shareholders are not misled or duped. This puts a legal and moral obligation on directors to make sure that the accounts really do reflect reality. In the US there is no such duty, as spectacularly illustrated by Enron. There, the rules try to anticipate every possible trick that the directors could get up to in the report and accounts, and then forbid it. This has spawned a vast industry whereby lawyers and accountants try to find legal ways around the detailed rules that nevertheless flatter the company's results. The result, amongst others, is the Enron Special Purpose Vehicles which allowed assets and liabilities to vanish from all public company balance sheets just because 3% or more was held by a private company. This simply could not happen under UK accounting rules. It was perfectly legal in the US, though it may not remain so for long.

This is a striking example of the point made in the 2002 Reith lectures: micro-management does not lead to trustworthy behaviour, it leads to clever handling of the micro-management rules. A clear statement of the legal and moral obligations **in principle** provides a much better framework for trustworthy behaviour. It does not guarantee it, but at least it lays down what is expected; then defining breaches and punishments is easier and more likely to be effective.

The issue is to make our existing Code of Conduct work, not to complicate it with US style intricacies which just spawn an avoidance and loophole-spotting industry!

3. Liability

What is the non-executive's position when it all goes wrong? I think it is right and proper that there is no legal distinction between non-executive and executive directors. To create a two tier system of responsibility would be incredibly divisive, and would positively encourage the (dying) lunch-and-monthly-board-chat brigade of non-executives.

However, having said that, I think it would be fair if responsibility were held in proportion to the rewards received. And if a non-executive director finds that there has been wrong-doing and they did not know about it, despite diligent and persistent efforts to ensure that they were properly informed by the executives, then any inspector or legal process should take this into account as a mitigating factor. This is not to say that they should get off scot-free, after all if there has been wrong-doing someone has suffered: creditors, shareholders, employees or all three. There needs to be a heavy incentive on non-executives to **ensure** that they are fully informed and to take the threat of future liability very seriously. Without the threat of legal responsibility, they may cut corners whether through laziness or sheer pressure of other things, and corner-cutting is something we cannot tolerate in such an important function as corporate governance.

This leads me to the view that there really has to be a limit on the number of non-executive positions an individual takes up. To legislate a precise number for this limit is impossible as circumstances differ so widely:

- A non-executive who has their own private support office can handle more companies than the sole operator.
- Some companies take up more time than others: if they are growing rapidly, perhaps making acquisitions or in a rapidly developing industry, then they take more time than a steady-state company in a quiet industry sector.
- Non-executives on the group board may automatically become non-executives of subsidiary companies. These typically take no extra time as the subsidiary boards may never meet. But the list of directorships is still one longer at Companies House, so it can look like a long list of directorships when in effect it is much shorter.
- Someone with a few non-executive rôles may be more heavily loaded than a person with more, because they are also involved in other things!

Non-executives need to act responsibly in allocating sufficient time to each company, and companies seeking a new non-executive director must make a realistic assessment of the candidate's

commitments, choosing the candidate who really has the time and ability to add value over the ‘big name’ who has too many such appointments already.

A final point on liability: I decided a few years ago, entirely personally, that the risks of being a non-executive of a US company are not justified. The playing field there is just not level – directors are at the mercy of egregious class action lawsuits brought about at no risk to the litigants, with often a minute chance of a huge return but sufficient to encourage the lawyers to pursue the case on a no-win, no-fee basis. The chance of a real win in court may be minute, but unfortunately the chance of an out of court settlement in order to free the company from the burden and distraction of fighting the case is quite high, and makes the whole game worth playing. I sincerely hope that we do not allow the UK situation to approach this, either through changes to legal practice or over-burdensome regulations.

Directors should be liable for the decisions taken in their name. This means non-executive directors must take the job seriously and put in the time required. Executive directors must also take governance seriously and give their non-executives all the information they need to do the job. Failure to do so is self-serving and deserves even higher levels of sanction.

4. Reward

The non-executive’s job carries identical legal and fiduciary responsibilities to that of the executive director. However it is facile to claim that the pressure is as great. Certainly there can be great pressure, especially at times of corporate transactions or business problems, but the CEO and other executive directors are not only on call 24 hours a day and seven days a week (as is the non-executive), but they are **much more likely** to be called. I do not therefore claim that the non-executive should be paid at the same rate pro-rata, some differentiation is justified. The question is how much differentiation, and the answer is not as much as at present! Of course I may be thought biased in this view, but I believe it is justified as follows.

Non-executive directors’ fees vary widely. For large companies they may well be sufficient but for midcap companies they are typically £25-30,000 pa for a time commitment of 20-25 days (including the extra time needed, beyond board meetings, as discussed above). Note that this has to cover **all** the non-executive’s costs such as running an office, a car, pension provision and so on. Consider

- The level of skills and experience that they have (or jolly well **should** have if they have been properly selected).
- The level of risk and responsibility carried.
- The fact that there are no other elements in their pay package such as pension contributions, car allowances, or bonuses.

This daily rate is clearly out of line. It is less than the same people would charge on a consultancy basis, for which incidentally they would probably carry little or no legal responsibility.

The history of paying low fees for non-executives is rooted in the Chairman’s-chum method of selection, and the ‘just come along for the lunch’ method of carrying out the duties. It belongs in the past. Another justification that is sometimes put forward for the low fees is that they must not be enough to compromise the independence of the non-executive. They must be low enough that the director will resign if something is wrong. Can only the rich be trusted to resign on principle? I don’t believe this is true, and we should not organise our corporate affairs as if it were true. Imagine the outcry if the equivalent argument was put forward with regard to audit fees!

Some say that the way to address this pay disparity is to pay non-executives in shares, or grant them share options so as not to burden the company with higher fees. On using shares I have no problem with that (so long as it is a fixed amount of **money** converted into shares at the current price), after all the director could just use the fees to buy shares in the open market. On options I used to subscribe to this view, but on reflection I no longer believe it to be appropriate. The rationale is to align the

director's interests with those of the shareholders. Can non-executives only understand the shareholders' interests if they have a related financial benefit? I don't think so. The non-executive also has a wider governance remit to monitor that the share price reflects reality. Reward packages carry an implicit message as to what really matters, and they influence behaviour. An option based package carries the message that share price matters above all else, and it is not many steps from here to the perfectly legal use of specially set-up subsidiaries to flatter corporate results at Enron.

Revenue recognition and cost policies are the more normal issues to be debated in terms of what is a fair view and what is a flattered view of the company's position, and I believe that the Board needs people to whom it makes no difference either way in the debate over what is the right policy. It *always* makes a difference to option holders. If we are serious about wanting non-executives to carry out the corporate governance rôle diligently and in the **spirit** of giving the shareholders a true and fair view of the company, then we should take the job seriously and pay a fair rate for it.

We should stop trying to get effective corporate governance on the cheap – pay a fair rate for the job in terms of experience required and the responsibility carried, and then demand the highest levels of performance.

Conclusion

The debate on the non-executive rôle and the future of corporate governance is definitely on. Lord Young's googly from the left field would be a disaster – can we really believe that corporate governance would be better served with **no** independent voices at the Board meetings? Certainly no-one that I have met takes this suggestion seriously.

My hope is that the debate will lead to increased recognition, reward and respect, especially from the CEOs, for the job we are trying to do to the very best of our abilities. My fear is that the debate will create more regulation, red-tape and risk for the non-executive director.

The debate is welcome and well timed, I just hope we avoid the knee-jerk micro-management conclusions and adopt instead a constructive approach, with non-executives taking the time to add real value. Then they will be able to challenge the thinking processes of the executive directors, rather than getting bogged down in extra regulations. This should also give non-executives more influence at the board table, which should result in more effective safeguards for shareholders' and stakeholders' interests.

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Appendix B

MPs and peers hold 819 directorships

By Jean Eaglesham, Political Correspondent

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More than 150 directorships are held by just 15 MPs and peers, and one in three of the lords has at least one directorship, Financial Times research has revealed.

An exhaustive study of the scale of directorships declared in the most recent registers of MPs' and peers' financial interests has found they hold 819 posts among them - an average of more than one job for every two parliamentarians.

The issue has particular urgency because the government is expected next month to publish the recommendations of the Higgs review - ordered in the wake of the Enron scandal - into non-executive directors.

Ministers have talked about limiting the number of non-executive posts any one person may hold and working to widen the talent pool from which they are chosen.

Lord Razzall, the leading Liberal Democrat strategist, holds 21 directorships; Viscount Chandos, a former Labour Treasury spokesman has 17. Neither could be contacted last night.

In a number of cases the multiple directorships relate to linked companies or subsidiary organisations.

In the Commons, Ian Taylor, former Tory science minister listed eight. Howard Flight - newly-promoted shadow chief secretary to the Treasury holds seven although he has said he will reduce this number because of his promotion. Neither could be contacted.

The level of boardroom activity has prompted a ringing denunciation of the politicians by the Trades Union Congress, which has questioned how those with many directorships can be serving either the public or the shareholders of the companies.

John Monks, its general secretary, said: "With a full time job representing constituents as well, the idea of MPs doing a proper job for many companies, even as a non-executive, is just pie in the sky."

The TUC will later this month call on the Higgs review of non-executives to ban individuals from holding more than five board seats.

But such a cap would cut the incomes of many peers. Even supporters of reform would suffer. Lord Sharman, who last month headed a Liberal Democrat group that recommended a maximum of five non-executive directorships "to limit the excesses of the merry go round", held eight posts according to the most recent register. Lord Sharman could not be contacted.

The party said the proposals were a "valuable contribution to the debate," rather than a limit Lib Dem peers and MPs had to observe.

The analysis, based on the latest registers of members' interests, shows that Conservatives hold proportionately far more boardroom seats than any other party. One in three Tory MPs and one in two Tory Lords is on a board.

But more than a quarter of Labour peers also sit on at least one board; several hold five or more directorships.

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