

**Non-executive directors – a note for the Derek Higgs review**  
**Jeremy Miles – member of ITNEA**

There is much attention being paid in the media, in boardrooms and by legislators to the role of non-executive directors. The impression is conveyed that we live in a culture where anything this side of the boundaries of the law goes, professionals have aided or even encouraged such behaviour, and it is left to the non-executives to become guardians of the moral gate; whilst exaggerated, there may be some truth in that.

In UK law non-executives carry the same responsibility as all directors although judges will normally make allowances for their obvious inability to become familiar with the detailed day-to-day workings of a company. In current expectations, they are supposed to assure good conduct by the executive directors and the company as a whole.

In these discussions, we need to remember that the board must function positively; all the directors have to work as a team having trust and respect between its members. A “secret police” culture would be horribly destructive.

This paper seeks to contribute to the Higgs review and to stimulate thinking on whether the legal and the perceived roles are capable of realisation, and whether the present way in which a non-executive directorship is filled and discharged is appropriate to the expectations.

Firstly, let us examine some of the things that non-executive directors are not:

- they are not back-seat drivers; however tempting it may be, they must avoid usurping the role and thus the responsibilities of the executives;
- they are not specialists; whilst they may well have particular skill or experience in, say, the company’s market or the City, the exploitation of that skill is not their primary role;
- they are not an insurance policy; the board as a whole is responsible for the functioning of the company, with the executives responsible for its day-to-day management.

Having established some of the things which non-executives are not, let us explore those which they can and should do. But first we will identify their essential characteristics. They must:

- be experienced business people, preferably with a reasonable knowledge of the company’s industry;
- have enough available time to handle demands as they arise;
- be strong-minded and able to argue their corner without becoming argumentative;
- if the need arises, be prepared to take hard decisions;
- be able and willing, as a last resort, to resign.

Those are quite demanding characteristics, especially the last three; history – not just business - is littered with examples of people in high places who did not live up to them.

Now we will turn to what they can and should do. In so doing, we assume as a premise the present UK preferred unitary board structure with a non-executive (or, possibly, quasi-executive) chairman, a senior non-executive, and a more or less equal balance between executives and non-executives on the board. There are other structures elsewhere but there does not seem to be any evidence that they are significantly more effective than the UK one.

- Non-executives need to earn the respect of the executives. Past experience helps but hard work is an essential;
- the chairman and the senior non-executive need to make themselves available for any executive to consult off the record;
- although it may seem divisive, the non-executives need to meet privately – in person or by conference call – reasonably often to share views and concerns;
- control of the executive directors’ – and, in some instances, that of people just below the board – remuneration should be exclusively with the non-executives. They should, of course, consult the chief executive in that matter;
- control of the audit should be exclusively with the non-executives. They should appoint the auditors, settle their terms of reference and remuneration, and agree the scope and plan of the audit. In so doing they should, of course, consult closely the finance director and may well wish to seek external financial advice from a firm other than the auditor;
- they need to be prepared – both in terms of willingness and preparedness – to meet shareholders and to seek an understanding of any concerns which they may have but do not want to express overtly.

Those are the regular functions – apart from general monitoring of the company’s health and progress along with the other members of the board – which non-executives should undertake. There will also be occasional matters, especially those of which the executives have little experience, which arise from time to time. Such matters may be very important but be outwith the company’s normal operations. There is always a danger that the executives, especially in smaller companies or if they lack relevant experience, can get so distracted by such matters that they lose control of the conduct of the core business. It may sometimes be appropriate for a non-executive, especially one with relevant experience, to take responsibility for such a matter.

Private communication with executives and with shareholders is an obvious source of danger; handled badly it can be a source of division and give rise to suspicion. Whenever possible, the non-executives should report to their executive colleagues that conversations have been held and, if they are not bound by confidentiality, the nature of the discussion. After all, the executive or shareholder has presumably approached the non-executive in the hope that something will arise out of the approach.

Thus far we have discussed non-executives in general. They fall, however, into two categories: executives of other companies and “full-time” non-executives, often people who have retired from executive responsibilities but who still have the energy and desire to work hard. It should be assumed that, except in special circumstances, ex-executives should not continue in a non-executive role within the same company.

The pool of “full-time” non-executives is presently limited by the statutory 70-year rule. Whilst some may, through circumstances, move from executive to non-executive roles in their late 50s or early 60s, it makes no sense to limit artificially the working life of those able and willing to serve longer. Active life expectancy has lately increased substantially and the pool can be enlarged by simply raising or eliminating the 70-year barrier rather than making post-70 service an exception. The chairman of the Federal Reserve Board is now 76.

The up-to-date experience of a non-executive from another company is valuable; it provides a basis for comparison in board discussions. Whilst many such non-executives are without doubt people with strong moral values, care must be taken that their empathy with their executive colleagues does not unduly colour their views. When the going gets difficult, an independent éminence grise may be more valuable than the current experience of an industry colleague. Non-executives who hold current executive posts in other companies should probably not form more than half of the number of nonexecutives.

That brings us to the relationship between the non-executives and the executives. There is a school of thought which proposes regular – perhaps three-yearly – changes of non-executives as well as of the auditors. Whilst that has a superficial attraction, the lack of continuity presents at least as many risks as those alleged to exist in longer relationships.

There are understandable concerns, especially where personal friendship exists alongside the business relationship, that the whole structure becomes too cosy. That, again, has a superficial validity. But non-executives endowed with the strength of mind and moral fibre which are a sine qua non for that role will not allow friendship to stand in the way of duty. Indeed, they may well be able to use their influence more effectively by reason of that very friendship.

Lastly, let us think about remuneration and resources. On the topic of resources - and by way of example - the view was espoused a little while ago that the non-executives should take responsibility for risk assessment in the company; that is quite impossible as the non-executives will never have the resources necessary to do such a job properly.

They are, under present arrangements, usually under-paid and under-resourced. In the days when they merely attended a few board meetings that was probably good enough, but with the extended role which is now needed they must have access to resources and be funded and remunerated appropriately. It is commonly held that they should be expected to resign without notice or compensation; that may be appropriate for those who are executives with other companies, but is unsatisfactory for “full-time” non-executives.

One difficulty is that the demands on a non-executive's time and resources – secretarial, research, analysis, the need for external advice – vary greatly within one company over time. The non-executive really has to determine what merits looking into more deeply and needs to have the wherewithal so to do. Somehow a scheme needs to be put in place which provides the funding for such variable workloads whilst not removing from the executives responsibility for the company's overall expenditure. Perhaps a basic level of compensation – probably somewhat higher than at present – should be set to cover time, research and the usual overheads, and a general fund established which can be used upon occasion at the discretion of the chairman.

### Summary

The essential characteristics for any non-executive are a strong moral sense, reasonably relevant experience, and the time and willingness to work very hard when the need arises. Those characteristics need to be tempered with a dose of pragmatism.

Because non-executives are supposed to be watchful for things which may be going awry, it is not possible to be prescriptive about what they should do or how they should do it.

The 70-year age barrier should be lifted or abolished in order to enlarge the pool of available experienced "full-time" non-executives.

Non-executives from other companies should not make up more than half of the total of non-executives.

Remuneration, funding and resources need to be appropriate to the requirement; compensation on resignation may need to be provided when the circumstances so warrant.

NB "Although I am a member of ITNEA, this paper is a personal contribution and does not necessarily reflect the views of other ITNEA members."

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