

## **REVIEW OF THE ROLE AND EFFECTIVENESS OF NON EXECUTIVE DIRECTORS: CONSULTATION PAPER**

### **SUBMISSION BY KEITH HAMILL**

This submission is in response to the consultation document issued by Mr Derek Higgs in connection with his Review of the Role and Effectiveness of Non-Executive Directors, which he has been asked to conduct by the Secretary of State for Trade and Industry.

My background is that after a career in accounting with PricewaterhouseCoopers and as the Finance Director of a number of listed companies, I was asked, at the relatively early age of 48, to become the Non-Executive Chairman of a number of listed and private equity owned companies. I currently serve as a non-executive director (“NED”) of a FTSE 100 Company and am Chairman of a FTSE 250 Company and a FTSE 350 Company. In addition, I Chair two small listed companies, one private equity owned business and serve as an NED on one other UK listed and one other small USA listed business. Out of a total available working days of 230 working days a year, my commitments amount to 160 days (giving flexibility for over runs of approximately 30%, assuming seven hour working days).

Having been engaged in this way for over two years I have found periodic increases in demand reasonably easy to manage and regard this as a rewarding ,stimulating and useful way to manage the final stages of my career.

In addition to a number of general observations, my submission mainly covers the issues of the skills required by NEDs, smaller listed companies and the proposed limitations of the number of appointments that NEDs should undertake.

### **GENERAL COMMENTS**

Although many of the recent incidents giving rise to concerns have in fact been outside the UK, it is clearly not acceptable for the business community not to respond to a general view that the effectiveness of corporate governance and of NEDs should be improved.

It would, however, be worth noting that there are no grounds to believe that greater effectiveness in this area would have been capable of avoiding the dramatic decline in the values of listed securities in recent years. This has predominantly arisen from previous over valuation, which was mainly a function of manipulation within the Financial Services sector..

There has been a tendency to overestimate the potential short-term impact of the relatively recent changes made to define and enhance the role of NEDs as part of our corporate governance system. The steps taken to increase the importance of checks and balances and divisions of responsibility have had beneficial effects. They will, however, need time to realise their full potential in changing the general behaviours and cultures associated with business management, particularly when the current generation of business leaders and NEDs developed in a different environment.

Even when fully effective the main impact of NEDs will tend to be to moderate excess, provide supervision and ensure proper consideration of issues. They cannot be wholly relied on to eliminate the possibility of mistaken strategies, wrong valuations and estimates or the possibility of optimistic presentation of information - although they can be expected to help reduce these risks.

The current statistics on average length of service for FTSE100 CEOs do not indicate that Boards are failing to remove under performing executives. A further shortening of this average period would probably be counter productive.

### **SKILLS REQUIRED BY NEDs**

The consensus view of those with experience of Boards (and similar groups) is that the key characteristics of a successful Board are a good balance among members who have a capacity to contribute effectively and who are therefore encouraged by colleagues to do so within an atmosphere of mutual respect. Within the requirement for balance, diversity and difference of viewpoint is an aid to analysis and objectivity.

However, it is also the case that much of the work of Boards is financially and legally based. To make an effective contribution to supervision and the development of strategy and policy, a significant proportion of the members of an NED team will need extensive financial and legal experience and the overwhelming majority of that group will need significant business and commercial experience. NEDs must be able to command the respect of Executives. Those who have served on Pension Trustee Boards with employee representatives will be familiar with the very real difficulties experienced by such representatives who do not have a financial or commercial background, notwithstanding their conscientious approach to their responsibilities.

It has been asserted that we have a weakness in the NED system because a small number of previous Chief Executives of large companies have taken a significant number of non-executive appointments in other big companies- sometimes in an environment of overlapping board memberships and with the possibility of mutuality.

This has understandably caused public concern over the risk of reduced objectivity and a lack of rational process and fairness in selection. In some respects it is disappointing that those involved have not responded to this criticism and made arrangements to restore public confidence.

To the extent that “greater diversity” refers to this issue, then it represents a reasonable point. However, the phrase could also have a broader interpretation relating to the involvement of the wider community (sometimes referred to as “stakeholders”) and those with little business experience.

Any attempt at a “representational” approach would be highly destructive of effective Board process and likely to greatly reduce the confidence of the providers of capital and the mutual confidence of all Board members. In addition, any move to reduce the relevant skills base of the NED group will inevitably reduce their effectiveness and capacity to work with the executive team while maintaining proper supervision. If the skills level of NED declined below current levels and below that of the Executives the credibility of the role could legitimately be questioned. This cannot be remedied by limited training -since the skills required will normally take many years of training and experience to develop.

In practice a representational or technically weak NED component of the Board would be likely to result in a “supervisory Board” style- with limited real control on the Executive. In such circumstances the Executive would clearly have a closer affinity to the providers of capital and could bypass the NEDs, who might not be held in high regard by executives or investors.

One often unspoken issue relating to NEDs is average age. While many older NEDs are highly effective, there is a risk that the average age of the NED group may restrict its potential vitality and possibly current skills and understanding. Current proposals to limit the number of post held by NEDs, particularly by those with full time engagements, will materially exacerbate this problem.

### **SMALLER LISTED COMPANIES**

Smaller Listed Companies generally have less complex issues but significantly fewer resources with which to meet them. There is a fundamental difference between a Company with sales of £25 billion and a capital value of £30 billion and one with sales of £100m and capital value of £30m. This difference is not currently recognised in corporate governance regulations.

The Board of a Smaller Company is likely to perform a greater role in relation to the operational management of the business and the value of the contribution of experienced NEDs in these areas is likely to be substantial. Conversely the value of highly structured supervisory activities is lower. Issues relating to such matters as independence may also be less important than issues relating to ability, experience and commitment.

In addition as far as the broader public interest issues are concerned, isolated cases of mismanagement are less significant in small entities.

Smaller Listed Companies have significant problems in attracting NEDs and an increase in these difficulties resulting from limitations on appointments would be onerous and possibly costly.

The original Cadbury Committee approached its developments in corporate governance practice by suggesting that its guidelines should in general be followed but that when they were considered inappropriate Companies should note non-compliance and give reasons. It was anticipated that these reasons might well be acceptable to investors and others and, therefore, compliance would be managed on the basis of reasonableness. It noted that this would be of particular help to Smaller Listed Companies.

Subsequently corporate governance practice has progressively adopted an increasingly mandatory tone, developing what has effectively become quasi-legislation. This has been compounded by supplementary codes from investing groups (some of which appear to border on having semi-political objectives), automatic voting services and pension trustee activism (particularly in local government controlled pension funds) that takes no account of the particular circumstances and do not consider reasonableness.

It is therefore particularly important that Reviews such as this one propose appropriate specific provisions relating to Smaller Listed Companies. In relation to NEDs it would be most helpful if Companies with sales under £150m or capital under £100m could be exempt from the current requirements relating to Independent NEDs and the use of incentives relating to shareholder value. It would also be helpful if they were exempted from anticipated limits on appointments and any other restrictions proposed by this Review. These could be replaced by requirements to provide shareholders with an explanation in the annual report of how the related issues have been addressed.

### **LIMITATIONS ON APPOINTMENTS**

It is widely anticipated that the Review will recommend that NEDs should be limited to five appointments and that those in full time employment should be limited to one NED appointment.

The NAPF have already proposed this limit by way of a requirement on those holding more appointments to justify so doing (which is going to be difficult given the

increasing demands for absolute compliance by voting services) and extended this requirement to appointments relating to Charities and similar bodies.

The basis of the proposed limitation to five appointments is an assertion that NEDs need to spend one day a week on each appointment. In the case of smaller and medium sized companies anyone who has undertaken this work will know that this is clearly nonsense. In practice it is questionable that even in the largest Companies there is sufficient routine work for NEDs to usefully occupy one day a week –since those businesses will normally respond to their size by having monitoring and reporting processes designed to deliver Company level information to the Board on a sufficiently consolidated basis so as to enable them to fulfil their responsibilities without the NEDs themselves performing detailed investigative and analytical work.

In addition, the one day week standard may actually diminish the standards of objectivity and detachment which at least part of the NED group needs to demonstrate. Suggestions that this could be overcome through involvement with divisional or subsidiary boards could also result in NEDs ceasing to identify themselves with overall corporate and shareholder issues and associate excessively with one part of a Company. Finally it is already anticipated that these restrictions will result in a significant increase in NED remuneration – which may also increase dependency and reduce objectivity.

There is a possibility that as in other areas of corporate governance the hastily proposed remedy will have the opposite effect to that intended.

In the event that the Review concludes the appointment limits are appropriate, it is desirable that the application of this regulation should be carefully defined. In particular:

1. It should apply only to FTSE 250 or equivalent appointments – this would achieve the objective of limiting the currently perceived abuse, while avoiding damage to smaller listed and other entities.
2. It should not apply to unpaid work for Charities, which would otherwise lose valuable experience which in practice is unlikely to interfere with NED work
3. It should not apply to private company appointments or family investment holding and similar companies, provided they are not large companies. This will reduce the effect to which regulations relating to listed companies disrupt the private companies (which should not be regulated in this hybrid way) and reduce the risk that the regulation accelerates the trend of our most able businessmen to working solely in the private equity sector.
4. Appointments to subsidiaries or divisions should not be taken into account if the holding company has already been taken into account.
5. Current appointments should be subject to a three-year phase out period in order to avoid the serious disruption and NED shortages arising from the proposals.

In addition. Boards, Nomination Committees and individual NEDs should be under a formal obligation to consider the adequacy of time available to undertake necessary NED work.

Unless a proposal to introduce “appointment limits” is clearly defined in this way there is a significant danger that they will be applied unreasonably. The risks of this will be that current arrangements will be seriously disrupted, with inadequate time to implement changes, an escalation of costs and materially reduced availability of skilled NEDs to medium sized and smaller entities and, as a by-product to other entities- particularly when such an outcome is not necessary to ensure that reasonable restrictions are developed in the case of major companies.

05.09.02

Filename: Keith Hamill.doc  
Directory: C:\tmp\work\R501110\KAREN\R501110  
Template: C:\Documents and  
Settings\kanese.DEVELOPMENT\Application  
Data\Microsoft\Templates\Normal.dot  
Title: REVIEW OF THE ROLE AND EFFECTIVENESS OF  
NON EXECUTIVE DIRECTORS; CONSULTATION PAPER  
Subject:  
Author: KH  
Keywords:  
Comments:  
Creation Date: 07/10/2002 11:03  
Change Number: 3  
Last Saved On: 07/10/2002 11:04  
Last Saved By: camassey  
Total Editing Time: 2 Minutes  
Last Printed On: 11/10/2002 10:18  
As of Last Complete Printing  
Number of Pages: 6  
Number of Words: 2,027 (approx.)  
Number of Characters: 11,558 (approx.)