

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

Summary of key issues:

1. Non-Executive should be changed to Independent.
2. Minimum of 3 NEDs in listed companies. 50% desirable.
3. Stakeholders to take specific action where abuses of Code are not corrected.
4. NEDs should not sit on each other's board. Maximum NED roles to be 5.
5. Qualifications, duties, & time commitment of NEDs should be disclosed.
6. Auditor standards need tightening.
7. Remuneration to be substantially increased.
8. Combined code generally works well. Some change needed but not legislation.

### **ISSUES FOR CONSIDERATION:**

**What role should non-executive directors perform, & how does this compare to the present position?**

**A1.** The role of the board is to optimise the profitable growth of the company consistent with the needs & reasonable expectations of its stakeholders, present & past employees & its customers.

To operate within the law and to have proper regard for standards of public & private integrity, & the effect of its actions on, & in, the community at large.

The Chairman should ensure that the size & the balance of the board is such that the strategy of the company is properly determined & regularly reviewed, that its executive directors are capable of carrying out the strategy effectively, & that communication with the company's diverse constituencies is maintained.

The annual accounts should include a statement on the respective roles of the Chairman & Chief Executive. The Chairman should also be required to state his policy on the role & responsibilities of the NEDs.

**A2.** The key role of the NED's must be to provide a supportive but questioning balance on the board. Theirs should be the contribution of experience in other walks of life to the strategy of the business. Its operations, international activities, government affairs, management selection & reward & general & specific opportunities and risks it may face. They are NOT there to run the operations! That must be the responsibility of the CEO, and the executive management team.

The balance of the board must to a large extent be governed by the size & complexity of the company. This is especially true in very large or very small businesses.

The "IDEAL" balance should have an equal number of executive & non-executive directors, with the Chairman's casting vote if it is needed. A minimum of three NEDs should be required in quoted companies. This is not necessarily acceptable in smaller listed companies (see section D), nor may it be practical, if, in larger companies, the US model is followed. Many of those have a majority of NED board members and probably only the CEO, CFO, & the COO as executive members. "The Barbarians at the Gate" provides salutary reading.

In practice, I suggest that NED's will fill different roles according to their experience, but combine their contribution on board sub-committees, & in board meetings.

**A3.** This may be answered by study of a selection of annual reports. The 'best' companies seem to achieve a proper balance as defined in the code, & a very small minority apparently, deliberately ignore it. It should be the duty of the NEDs & stakeholders to take action, in conjunction, where such abuse exists, & not call for further legislation on ALL companies. Regrettably, government or it's agencies can be particularly prone to take embracing action when the worst cases are revealed, without seeming to take into the account the proper conduct of the majority. This is not the way to ensure compliance, even though it may placate the populist media.

**A4.** This question is better answered in section B. However an NED who is chairman of a board sub-committee, will need to be seen as the independent leader for that position, & have the necessary experience.

**A5.** Acquisitions, Sales, Diversification, Takeover offers, Geographical expansion, Redundancies & Closures, Board appointments & promotions, Remuneration, Dividends, Profit warnings, Audit, Financial structuring, Health & Safety, Environmental issues etc. All these have the potential for conflicts of interest & require board meetings, both formal & informal to build trust within the board before these arise. The whole board needs to understand that "This is the way we do things around here", & be confident that this way, the right way, does work, & that sensible discussion will avoid conflict, but allow rational disagreement. The chairman & the chief executive should be responsible for taking the lead.

To be truly independent & avoid conflict, it must be self evident that directors should no longer sit on each other's board as NEDs.

**A6.** Time commitment is the most difficult criterion to accurately define where the role is non-executive. Size & complexity of the business are important determinants, as well as the success or problems within the company at any time. A chairman will probably need to devote between 50 to 150 days a year in a quoted company, & 30 to 50 days in a small listed business. NED's time commitment will range from 20 to 50 days plus, if chairing sub-committees or acting as senior non-executive or deputy chairman is taken into account. Some minimum commitment should be agreed with the chairman, if they are to devote sufficient time to ensure they know how the business operates & keep properly in touch with issues, & this should be disclosed in the Annual report.

. What is an appropriate measurement of time? Board meeting days are easy to define, as also site visits. A visit to London for two hours, which takes 3 hours travel? Extensive reading, phone calls at any time, minor or major crises, interviews etc, sub-committee obligations & study of ever increasing regulation. Not a simple solution, & possibly a deterrent to becoming a NED, unless the obligation is made clear & the rewards are commensurate with the time & risk involved.

I have found, that as a career NED, after an executive career, FIVE concurrent posts were a maximum. I would note, in passing, that a serious NED who gives time & interest to a post usually finds that the demands on his time in that post increase as the executive colleagues ask for more help & advice!

On the other side of the equation, I believe that it is generally inappropriate for any executive director to hold more than ONE appointment as a NED, & some guidance on best practice should be included in the code.

Indeed it can be argued that some limitation would open up more positions for NEDs, particularly for those who may wish to pursue this role as an active career, rather than a role post retirement.

**A7.** The role of senior NED is confusing. If the chairman is unable to be present then it may denote his 'independent' deputy at a meeting, though I believe that a deputy chairman appointment gives greater clarity. I do not believe the senior NED title is sufficiently clear, nor the task understood.

**A8.** At present the legal duties of all board members are the same, & I suggest this does, for the large majority, ensure due diligence. It is hard to see how to distinguish the different board roles without diminishing this. Nevertheless it must be recognised that in the real world NEDs are unlikely to uncover deliberate fraud or malfeasance by a determined executive, especially if there is willing or unwilling collusion by other executives, until it is too late. Increasing calls for penalties on all board members, for fault, is understandable, but may discourage some from accepting a NED role, without guarantees that are impossible to give. Insurance provision may be welcome, but is not the answer.

**What knowledge, skills & attributes are needed, & what can be done to attract, recruit & appoint the best people to non-executive roles?**

**B9.** The key skills needed by NED's are to some degree dependent on the needs of the company. Common sense requires the necessary background, but it would be unwise to rely on professional qualifications alone. It is essential to check the experience & breadth shown by the candidate's cv and references, as well as the likely fit of personality with future colleagues.

As a guide, NED's need 20 years of commercial, professional or public experience, which should include success at, or near, the top of a major company department or subsidiary board, & preferably time on a PLC board. Knowledge of the industry, unless there is a very specialised requirement, is less important than a good track record, & a broad analytical mind. Basic finance, company law, personnel & governance matters need understanding, but the primary need is to bring to the board an additional skill which adds knowledge that the board lacks in depth, & which complements the strength of the team as a whole.

The next ten years will require increased familiarity in advanced I.T., international legislation, brand marketing in a changing world & practical "just in time" organisation & logistic systems. but, do not forget the HUMAN resource.

**B10.** To some extent this is answered in the section above. It is, however, quite clear that for a NED to fulfil the role to best advantage, enthusiasm & commitment to the company is essential. There is no need to agree with everything, indeed that would negate the role, but support for the strategy & the board, & pride in the position, internally & externally has to be seen.

Most of all a NED needs to have the mindset & the courage to ask the unthinkable, challenge accepted wisdom, suggest positive alternatives & possess an open style & enquiring wisdom & the desire to learn.

**B11.** For the board to be balanced, I would reiterate that a different background is necessary for NEDs. Some experience may be parallel, but in different situations, so that one feeds off another.

For example, in one stage in my career I was an NED on a board in the UK that had made a poor acquisition in Australia. I had personal experience of other business there, and was able to find a company in Australia willing to purchase it at a sensible price & solve the problem. Similarly, as chairman of a remuneration committee, I had regular contact with one major life company. At a later date, as Chairman of another company, I had to seek their support in a share buy back. My corporate governance contact enabled me to meet the appropriate senior manager and negotiate this on a friendly & proper basis. This, in turn, brought the support of others. There are plenty of examples of NEDs acting as key facilitators when necessary, & can be an important contribution.

A great deal more needs to be done to attract women to fill many of these NED roles. I believe their contribution does make a great difference to board discussions & decisions, as they add a distinctive point of view on many issues. The potential pool is widening & needs using.

**B12 & 13.** There appears to be a large pool of possible candidates for NED positions. Certainly, search consultants have long lists, but to find candidates who are prepared to accept some risk, & have the right attributes for a role, can be time consuming & costly.

I am not sure how nomination committees can be improved. One accepts that the burden on their interview time is demanding, and selection may be speeded by delegating to a sub-committee at the early stages, but it is also difficult for candidates attend successive interviews. The better the candidate, the less time they have already! International representation may be desirable, but is more likely to be important to Multinationals or those with interests in the Eurozone. What is true, is that the better the reputation of the company, the easier it is to find potential NEDs. This, of course, reduces their potential personal risk.

There are other factors to take into consideration. First, it seems that business is less willing or able to encourage senior executives to take up at least one outside appointment, even though this is a good way to broaden their experience. Pressure, in house, takes priority. Secondly, possible personal risk and a prospect of more punitive legislation have assumed such a high level of public interest (whether true or false), that the extra commitment as an NED, does not seem attractive. Insurance provision is a subject often now raised, and is important to many.

Third, & finally, Remuneration: Various reports seem to confirm that levels are increasing in leading companies, but when actual time & risk are taken into account one has to conclude that in many cases there is further to go. My personal belief is that a salary that takes into account board & committee time & responsibility & any special duties is the proper form of reward. It is not open to any undue performance enhancement, which "could" lead to a conflict of personal interest. I am not in favour of stock options in place of salary. Shares do not pay bills for those who are persuaded that pluralism is a proper and interesting career.

I am, however, in favour of encouraging NEDs to own shares in their company, whether by personal purchase, or up to say the value of their annual salary through some deferred option. Or both. Share ownership is properly seen as a shareholder commitment, but should not become a means of enhancing significant wealth, if independence is to be preserved.

Overall I suggest that to attract & recruit the very best NEDs, reward levels need to be substantially higher, & the requirements of time & performance need to be more clearly & openly specified.

**Do existing structures & procedures facilitate effective performance by non-executive directors?**

**C 16 to 19.** The issues surrounding the working of the combined code can best be summed up by saying:-“In the best companies the combined code is working in principle as well as in practice”. It is hard to believe that more prescriptive provisions will influence those who neglect the code, and indeed there is a danger that such a step might make it more difficult to achieve general acceptance.

The balance between executive & independent non-executive directors does work, although the provision that non-executives should not be considered independent after nine years, even if their appointment is endorsed at the AGM, is an unnecessary restriction. Whilst it is undesirable that the board should be a self perpetuating oligarchy, the need for an NED who can provide a long term perspective is also important, as the length & continuity of service of executive directors is diminishing. In such cases, retirement at seventy should still be required, but up to that age length of service should only be dependent on performance, & desirably an annual medical at the company's expense.

Where they are properly in place, board committees work well, and help to secure an effective contribution by NEDs. Equally board meetings, benefit from the need to take the work of committees into account. It is hard to see how the size of the board can be codified as circumstances are so different. In general, one might presume that a smaller board might reach decisions more quickly, but would they be any better?

Audit committees are an effective method of independent scrutiny of company accounts & policies, especially when lead by an experienced financial NED. The question is of course apposite at present. It should be stressed that there are dangers & costs involved in the proposal to change auditors every 7 years, as they too acquire knowledge of the company, which gives continuity in accounting standards. More to the point should be the change of Audit partners within a similar period, as well as a review of audit performance, by the committee, reporting to the board, as well as stakeholders in the annual report.

Whilst it is normal to review the performance of executive directors each year, & this is part of the duty of Remuneration committees, performance of NEDs is rarely formally set down, though it should be managed informally by the Chairman & the Chief executive. It is not in anyone's interest to accept poor performance of any duties. Shareholders should be informed of the specific duties of NEDs & their attendance records at specified meetings. Bearing in mind that the nature of their other obligations may affect this, proper comment should also be provided..

One final & important point:- The term “**NON EXECUTIVE**” director hampers the understanding & status of their responsibilities, which are the same as the executive directors. “**NON**” means precisely that to the uninitiated, & I suspect it is seen as such by some stakeholders, which may account for the obviously weak relationships. I suggest that the committee should consider this carefully as a recommendation to the Company Law review. The term “**INDEPENDENT DIRECTOR**” has a more positive connotation, which can be clearly understood. Try explaining the work of a NED on the shop floor, particularly when public perception is coloured by myths of neglected duty & eight to ten lunches a year.

### Do existing relationships with shareholders or others need to be strengthened?

**D.23 to 26.** The need to strengthen external relationships, depends to some extent on the stakeholders themselves. Generally the Chairman & the CEO & Finance Director are the main points of contact for institutions & this seems to be appropriate & consistent with their responsibilities. Other executive directors deal with the specifics of their posts as necessary.

NEDs are rarely brought into contact other than attending presentations to the institutions, particularly at interim & annual results. However, chairmen of sub committees, especially Remuneration, do find themselves answering questions. Those from most institutions are sensibly framed & require a proper response, which is respected & dealt with satisfactorily by telephone or letter.

I can only recall one occasion when, as Deputy Chairman, I was summoned by an institution on a matter of importance. As Chairman, I have been expected to maintain contact with stakeholders, with no requirement from them for my NED colleagues. It is unfortunate that approaches to NEDs are more usual in a ‘crisis’. Yet one must question whether more regular meetings would help in adding greater understanding of the company aims & achievements which should already be properly communicated by the Chairman & the executives. The only advantage would be to confirm matters such as management & succession plans, & of course to take a view on the quality & activities of the NEDs, & their independent influence. It would perhaps be helpful to require NEDs, after the annual general meeting, to be available to meet shareholders with a 1% or more holding in a question & answer session.

### How can non-executive directors best be supported to perform their role?

**E. 27 to 30.** The provision by the executive directors of regular & detailed monthly accounts & full financial disclosures ought to be a standard procedure. Whilst reports on all aspects of the business should also be made, the most effective information flows are those where the NEDs can, & do, telephone or talk to the executives in an informal manner to pass information to them or ask questions about any particular concern. This is not, in a well run company, seen as by-passing the chairman or chief executive, but rather a matter of total confidence between people working as a team.

Training & development is available from different sources, but much depends on the experience of the NEDs themselves, who often, because of their age & background, have more overall knowledge than the executives. That should be one of their attributes. Where training can help is often in the practical operations of the company, which may be different from previous experience. All directors need regular training in the increasing complexity of regulation, which affects business, often due to EU rather than UK requirements.

Induction programmes are normal, but also depend on the experience of the new NED. In the same way, guidance on expectations of individual contribution should be discussed before appointment so that both parties are clear. Feedback on performance is the responsibility of the chairman or chief executive, & within this comes discussions on what further responsibilities the company could require, & whether the NED has the time. This is often a key factor in the cooperation of the whole board in moving the business forward.

### In what ways is the position different for smaller listed companies?

F.31. I suggest a different provision is needed for smaller listed companies, & this will require precise definition. It is certainly less easy to attract high quality NEDs. It is important to have at least one independent NED, who should if possible be Chairman, although family priorities may intervene. The NED must then be prepared to remind the board of their duty to all shareholders, and if necessary, insist on independent professional advice being sought. The relative cost of NEDs, added to more stringent listing & accounting rules, may not be in the best interests of encouraging small companies to join the full market.

### What can we learn from international experience?

G.32 to 34. Recent discussion on corporate governance has highlighted differences with other international practice, in favour of the UK. Unless there are solid grounds for changing current practice, which would imply substantial disruption & cost, then the present overall UK standards should remain, with the exception of some modifications suggested. Change can best be pursued in the interest of the protection of stakeholders by bringing international accounting, listing & disclosure standards into line, & ensuring their enforcement.

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