# Review of the role and effectiveness of non-executive directors

**Response to the review conducted by Derek Higgs**

**September 2002**

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## 2. General

PIRC welcomes the Review and its terms of reference. We share the view that the role of non-executive directors is central to the effective functioning of boards and companies, and to their accountability to shareholders and other stakeholders. Achieving an effective corporate governance structure within the UK=s listed companies is vital for the competitiveness and performance of the listed corporate sector, for investor confidence in future performance, for the accountability of companies to shareholders and others, for the attractiveness of London as a market for Listing, and for enhancing the integrity and reputation of business as a whole.

As the Consultation Paper notes, non-executive directors play a central role in the achievement of good corporate governance. While, we consider this role has been enhanced and made more effective over the past decade, the concerns expressed over the role of non-executives in the wake of the Enron affair and other corporate collapses (specifically lack of oversight, independence and effectiveness) bear a remarkable similarity to criticisms leveled at boards in the late 1980s and early 1990s. This indicates to us that there is no room for complacency and still considerable progress to be made.

When we can still have disasters on the scale of Marconi and others after 10 years of governance reform, it is reasonable to ask whether it is sufficient to seek ways to strengthen the current system, or whether a more fundamental reappraisal of the roles and functioning of boards of listed companies is in order.

There is now a clear choice between continuing with piecemeal incremental reforms within the current framework, or exploring more radical proposals.

We note the government=s preference for a best practice approach rather than regulation, but we consider that this should not preclude the Review from considering more robust proposals, and possible new regulation where necessary. Many of the issues raised by the Review are too important to be left to incremental and organic reform.

Our detailed responses to the consultation questions we believe to be most relevant follow. PIRC=s focus is on the listed company sector, and except where noted, our comments relate only to listed companies.

## 3. Responses to consultation questions

## A: Role

**What role should non-executives perform and how does this compare to the present position?**

We agree with the Cadbury Committee=s conception of the role of the board as Asetting the company=s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship≅.

Within the current framework of a unitary board NEDs perform two basic functions:

X advisory in terms of scrutiny of issues of corporate strategy and

X supervisory in terms of monitoring executive performance and acting where there are conflicts of interest.

In each case, non-executives are perceived as having a special role in representing the interests of shareholders vis a vis the particular interests of executive management.

We have no doubt that some of the excesses of the past few years, which have destroyed shareholder value, are the result of failures on the part of some non-executives to adequately perform these functions. Ill-judged technology-based forays, value-destroying mergers, overly aggressive accounting policies, audit scandals and inappropriate remuneration incentives are testament to this. Of course, non-executives cannot bear the sole responsibility, but if we accept the current unitary board framework, there is an urgent need to strengthen the effectiveness of NEDs.

**Alternatives to the unitary board**

A key issue is whether supervisory functions can be performed within a unitary board. At present, there is a legal fiction that all directors are equal. However, there are clearly inequalities in knowledge, personal commitment, and financial interest between the executive directors and the non-executives. There are also clear tensions between the supervisory functions expected of non-executives and the collegiate nature of a unitary board. We must ask whether it is reasonable to expect a non-executive to be able to perform a rigorous supervisory role within the current structure. It may well be that some of the failures of non-executives to exercise satisfactory oversight over executives arise from the unitary board structure.

It seems clear that the obligations and responsibilities being placed on non-executives can only increase. Perhaps the differences between executives and non-executive roles should be recognised in structural terms through the creation of separate supervisory and executive board structures. We recognise that there is general support for unitary boards in the UK at present, but we are not convinced that the tensions between the executive and non-executive role can be reconciled within the unitary structure for listed companies.

The unitary board with a mixture of executives and NEDS is not a universal organisational model. It is not prevalent in other non-commercial walks of life or in other countries. Perhaps we should be asking if combining a supervisory, advisory and executive function in one body is tenable. Separation of >non-executive= supervisory functions from day-to-day management is the norm in the voluntary sector for example.

Separation of functions would also help to deal with the perhaps unreasonable expectation that executives will be able to put aside their personal interests to act in the interest of the company as a

whole, when they meet as directors.
The usual objection to a two-tier board structure is that it may reduce supervision through lack of interaction between the non-executives and the management. This is a very real problem, which could only be overcome through the commitment and calibre of the non-executives and the provision of high quality information from management. Similar challenges face the current unitary structure.

Therefore, without prejudging the issue, we would support a fuller and more serious exploration of two tier board structures than has hitherto been attempted. Having made this general point, the rest of our comments are in the context of the unitary board structure.

**Clarification of roles**
We believe that there is an urgent need to clarify and define the role of all directors. For this reason, we support the statement of directors= duties as proposed by the Company Law Review. However, we also consider that there should be a legal definition of a non-executive. We argued to the Company Law Review that such a definition should be based on a director who receives only fixed fees and is not an employee of the company or its subsidiaries. The particular responsibilities expected of a non-executive may also be set out in best practice guidance.

**Majority of NEDS needed**
We believe that to perform both the advisory and the supervisory function, it is important for NEDS to be in a majority. We note that the New York Stock Exchange Listing Rules will require a majority of independent directors on boards. Boards should not be dominated by executive management who are likely to face conflicts of interest between their own position as employees and their duties as a director. While three-quarters of FTSE100 companies have a majority of NEDS, for most midcap and smallcap companies they are not in a majority.

**More independence**
Everybody would agree that independence of character or mind is vital. This cannot be assessed consistently or objectively from outside. However, demonstrable independence from management interests or from a financial interest in a particular decision is also important. We recognise that external assessments of independence are not ideal, but the appearance of independence is almost as important as the reality.

There is a debate among various bodies over independence criteria but there is also much consensus. Whatever criteria are used it is clear to us there are too many question marks over many NEDS= independence. By our criteria, only a fifth of FTSE100 boards have a majority of independent directors on the whole board. This dwindles to barely 5%of smallcap company boards. Even among the non-executives alone, 35% of companies do not have a majority of independent directors.

The main factors affecting independence are length of time on the board, former executive status, representing a notifiable shareholder, holding share options or connection with a professional adviser.

**Role of the chairman**

There is often confusion over the status and role of company chairmen. They are variously described by companies themselves as non-executive, executive or neither, labels that sometimes bear little relation to the amount of time they appear to devote to a company or their levels of fees (or salary).

We consider that there are particular problems with a full-time executive chairman role whether or not that role is combined with the chief executive. We consider that the proper role of the chairman is in relation to the functioning of the board in ensuring effective discussion and decision-making, oversight of strategy, supervision of management and governance arrangements. In other words the role is about ensuring that the board processes function effectively.

Confusion arises when a chairman also has an executive management role. For this reason, we would argue that chairmen should never be executive, and that regulations should ensure separation. However, it is another matter whether it is possible to describe a chairman as properly non-executive. Certainly among larger listed companies, where running the board may take up considerable time, it is more reasonable to see them as neither executive nor non-executive.

**Time commitments**

Much has been written about the need to limit the number of non-executive positions. Clearly non-executives must have adequate time to perform their duties and must be able to maintain a clear focus on their responsibilities. This implies a limitation on the number of positions they can take up. However, there are problems in defining a maximum number of positions. Companies vary in the time they require, additional roles (such as board committees) will take up additional time and other responsibilities such as charities or voluntary organisations may take up just as much time as a listed company.

However, in light of the level of concern over the effectiveness of non-executives, we consider it important that boards should clearly explain to shareholders how their directors have sufficient time to devote to their responsibilities when they have multiple positions at major organisations. To provide assurance, it would be better to set this explanatory requirement at a relatively low level, for example three major positions. In appointing non-executives, boards should specify the amount of time they expect of non-executives and there should be transparent appraisal mechanism in place to assess the level and quality of the contribution made by non-executives with associated reporting (see below).

Additionally, much can be done to improve the consistency and comprehensiveness of disclosure of directors= position within biographies. These continue to vary enormously between companies with lack of information on all directorships and omissions of major non-commercial positions common.

## 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 roles?**

**Increasing diversity of experience on boards**

In order to be able to contribute effectively, NEDS need a variety of experience including general business experience, specific experience of the company=s industry, relevant managerial experience within a major organisation and senior decision-making experience.

We consider that business experience is too often emphasised as the most important knowledge base, which automatically limits the pool of non-executives to current or former directors at major companies. Indeed, it can be argued that requiring a business background represents a limitation on the experience upon which boards can draw. Most companies face similar challenges and dilemmas to many other large organisations. Experience of dealing with strategic organisational issues at a high level could be just as valuable. As a greater emphasis comes to be placed on the social impact of companies, their stakeholder relationships and their intangible assets, experience of dealing with such matters is likely to become more valuable. It is unreasonable to expect all non-executives to possess all such experience. The most important thing is to achieve an effective balance of experience round the board table.

**Personal qualities**

In terms of their personal qualities, non-executives also require attributes such as independence of mind, independence from management, integrity, time available, common sense, commitment to the company, ability to work in a team, judgement and communication skills.

We do not argue that all non-executives must be independent of management so long as there are sufficient numbers of other recognisably independent directors. However, we would argue that the other qualities are pre-requisites for all non-executives.

**Improving recruitment**

We are aware of concerns expressed by companies and executive search agencies about difficulties is recruiting non-executives. We consider that many of these problems arise from the approach currently taken. Since senior business experience is usually the criterion, this necessarily limits the potential candidates. Recruitment is also rarely undertaken in an open manner. Relying on head-hunters or personal contacts is insufficient.

We consider that the process should be professionalised with lessons learned from other types of recruitment. The Nomination Committee (comprising solely independent non-executives) should identify the key skills and experience needed on the board and draw up a person specification. A more creative approach to assessing acceptable skills and experience should be adopted. Head hunters could be employed but posts should also be subject to open advert. Above all, companies and boards must start to send out signals to make it clear that candidates from non-business backgrounds, but who nevertheless have relevant strategic experience within organisations, are

welcome to apply. Clarification of the role of a non-executive and the tasks expected of them is important in attracting potential candidates who currently may not consider themselves suitable. In addition, listed company boards should adhere to equal opportunity employment practices.
The consultation paper raises the issue of greater international participation in UK boards. We support this so long as the candidates can commit to attend at least half the required meetings in person.

**Payment for non-executives**
Methods of payment for non-executives are anachronistic. While most receive fees from the company on the basis of letter of appointment, some have employment contracts and others consultancy agreements. These arrangements can lead to questions over their status. Similarly the size of payments varies considerably within companies and certainly between them. Reasons for differential payments are usually obscure.

In order to clarify what non-executives are expected to do, we consider that a standard non-executive contract should be drawn up that specifies their terms and conditions, duties and obligations, and their levels of payment. These should be open for inspection and summarised in the annual report as for executive directors.

On the present level of information about non-executives= duties and contribution, we do not consider that they are underpaid, at least in the larger listed companies. However, we recognise that expectations and responsibilities are growing, and we add to these in this submission. If shareholders are assured that non-executives are contributing more and fulfilling their responsibilities more effectively, we see no reason why they would not countenance paying them more. However, increased payments must be based on a transparent appraisal process and a clear demonstration of increased contribution and effectiveness.

We primarily support payment in cash. Payment in shares can preclude people who require a cash income. We are sceptical about whether there can be a true alignment between the interests of directors and shareholders simply by requiring directors to hold shares. A director=s duty of loyalty to the company should be enforced through a proper understanding of their duties rather than through a financial interest in the share price which is often an inefficient and volatile measure of value and performance.

## C: Structures and accountability

**Do existing structures and procedures facilitate effective performance by non-executives?**

**Combined Code and regulation**
The principles underpinning the Combined Code are laudable but many of the provisions set the floor for acceptable practice too low. For example, a requirement for a third of the board to be non-executive and a majority of these independent, can, and does, lead to independent directors being in a small minority on many boards.

We consider that non-executives must be in a majority if they are to be able to supervise the executive management effectively. Absolute numbers of different types of directors are less important than the proportions on boards.

There is also a major issue in relation to the enforcement of the Combined Code. Ensuring compliance with the provisions of the Code has been left to market practitioners. As we argued to the Company Law Review, we consider that there is now sufficient consensus around the main tenets of the Combined Code to justify setting a legal floor on the proportion of non-executives on boards to underpin best practice recommendations.

We would draw attention to our views on the size and composition of boards and committees set out in our Shareholder Voting Guidelines.

**Board committees**
We support the basic structure of board committees as it currently exists. However, we consider they should all comprise solely independent directors. Each committee should report to shareholders on its activities during the year as part of the annual report and their terms of reference should be available.

In particular, we consider that changes should be made in relation to recommendations for nomination committees. Just as over audit and remuneration issues, executive directors face a conflict of interest in nomination matters with the danger that they will seek to promote their own candidates, so nomination committees should comprise solely independent directors, though they will of course consult with executives over executive director appointments. Greater independence of nomination committees is also important for promoting a diversity of opinion and experience in the boardroom. We note that the NYSE Listing rules require all board committees to be fully independent.

**Appraisal**
One of the major issues of importance for improving the effectiveness of boards is that of appraisal. Only 5% of companies report the existence of appraisal processes, yet for any other senior post, appraisal is seen as a vital tool for improving performance. We consider that there should be transparent and systematic processes in place both for boards as a whole and for individual directors.

In terms of collective appraisal, boards should consider how they are functioning in terms of issues such as their ability to reach decisions, the quality of discussion they have, the quality of information they receive and any major gaps in knowledge or experience. Such a process should be led by the chairman, though with the other senior non-executives having a major input as many issues may relate to how well the board is chaired.

For individual directors, there should be a regular opportunity for their contribution as directors to be assessed. Attendance at meetings, evidence of their having briefed themselves, their quality of input and usefulness of comments could all be gauged. A number of forward-thinking companies have such arrangements in place, often facilitated by an outside third party.

The most important thing for shareholders to know is that there is a rigorous, fair and independent process in place, rather than the specific outcomes. However, in order to demonstrate this, it may be necessary to provide a description of outcomes in the annual report, in general rather than personal terms.

The existence of a fair appraisal process would also deal with the potential issue of the proper removal of a director. Many companies have article provisions that allow boards to remove a director either by unanimous or majority vote. We have reservations about any such action without shareholder approval, as a safeguard against the removal of a dissident director. However, the operation of a transparent appraisal process would go some way to removing these concerns.

**Separate meetings of non-executives**

We would support non-executives meeting separately from the executive directors prior to board meetings to discuss matters of common concern. We note this requirement in the NYSE Listing rules.

## D: Relationships with shareholders and others

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

**Meeting institutional shareholders and stakeholders**

Our experience is that non-executives hardly ever participate in meetings with institutional shareholders, even when matters of remuneration or strategy, in which executives have a conflict of interest, are being discussed. It does not appear that building relationships with institutional investors or canvassing their views is part of a non-executive=s remit at present. This is a major failing. We are also struck by how often non-executives are absent from the AGM.

Likewise, while non-executives may sit on community or donations committees, their contact with stakeholder groups is usually equally limited. Again, this limits a non-executive=s effectiveness given the increased emphasis on the value of stakeholder relations in contributing to performance and managing risk.

We consider that non-executives must have a higher profile with shareholders and stakeholders if they are to be able to perform their functions more effectively. We consider that there should be an annual opportunity for non-executives to meet their major shareholders, without executives present. At AGMs, every effort should be made by the chairman to ensure questions are answered by the appropriate committee chair, rather than by himself.

We have argued in relation to the Company Law Review that formal consultation structures with stakeholders should be put in place, if directors are to be able to take account of the impact of their decisions on stakeholders, as the proposed statement of directors= duties requires. Such structures should include non-executives.

Increased activity on these issues implies a considerable extra commitment by non-executives. This, of course, should be remunerated subject to appropriate appraisal structures being in place, as argued above. Of course, more contact also implies increased commitment to such meetings from many investors.

In relation to senior management, we would also support the opening up of more contact with non-executives. While it is important that non-executives should not seek to circumvent the executive directors, familiarisation with senior executives and their functions can only improve a non-executive=s effectiveness.

## E: Support

**How can non-executives best be supported to perform their role?**

**Improved resources**
It is vital that non-executives have better administrative and policy support. There should be a secretariat function solely to support non-executives and non-executives should have budget allocation specifically to enable them to seek outside information and advice. Just as some remuneration committees are developing the right to seek independent advice other than that provided by the company=s remuneration consultants or the in-house HR department, it is a appropriate for other committee and non-executive functions to be so supported.

This secretariat function should be separate from the Company Secretary=s department, whose responsibility is servicing the whole board. We are concerned that at many companies, the Company Secretary effectively performs the role of an executive. Indeed the role may be wrapped up with that of an executive director. This can undermine the Company Secretary=s independent role as an officer of the company.

**Training**
We support initial and ongoing training for non-executives, and indeed for all directors. This is another area where disclosure is lamentable at present in spite of there being a Combined Code provision. The type of training undertaken, its frequency and who delivered it should all be reported. This should all feed into the appraisal process as well.

Directors need training on their roles and responsibilities, the main corporate functions over which they are exercising responsibility, and corporate governance issues amongst others. We broadly support the various initiatives to improve training though we recognise that there is still progress to be made to improve the scope and rigour of these.

## F: Smaller Listed Companies

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

We do not accept that there should be different provisions for smaller companies so long as they are listed. The decision to raise money from the public should imply the existence of similar safeguards and standards no matter what the market capitalisation. We recognise the difficulties that some smaller companies can face in terms of achieving compliance, but we consider the resources required for improvements in governance to be an investment in the future of the company. Failure to devote resources is short termist.

## G: International context

**What can we learn from international experience?**

Please see our earlier comments on two tier boards.

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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
Subject:
Author: Stuart Bell
Keywords:
Comments:
Creation Date: 07/10/2002 13:10
Change Number: 3
Last Saved On: 07/10/2002 13:11
Last Saved By: camassey
Total Editing Time: 4 Minutes
Last Printed On: 11/10/2002 10:08
As of Last Complete Printing
Number of Pages: 11
Number of Words: 3,867 (approx.)
Number of Characters: 22,046 (approx.)