

Our Ref: RJC/se/14322

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c/o Non-Executive Directors Review
Room 2142
1 Victoria Street
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Dear Mr Higgs,

**REVIEW OF THE ROLE AND
EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS**

In response to your consultation paper and as a barrister who has been a UK listed Company Secretary for 17 years and, more recently, an executive director for a listed company, I would wish to join this important debate. I have worked with a large number of executive and non-executive directors of varying quality and aptitude over the years.

Responding to your specific questions: -

A. ROLE

1. Role of Board

The Board's role is to manage the Company for and on behalf of and to provide accountability to its shareholders.

2. Key Roles

The Chairman's role is, in my view, the most important of all the directors, including the Chief Executive. A good Chairman will set the entire tone and ethos of the Board and the Company as a whole. In principle, I am not opposed to executive Chairmen, provided their role is clearly defined and distinct from the Chief Executive.

Generally, however, I would not anticipate that there was enough work to justify a full-time Chairman and a full-time Chief Executive except in the largest companies.

At its simplest, the primary role of the entire Board is to devise strategy and it is for the executives to implement that strategy. Having agreed upon a strategy and delegated to the executives its implementation, the entire Board is thereafter accountable for its strategy. I regard as retrograde any proposals to distinguish between the legal duties of any categories of directors in their role as directors. Boards should have collective responsibility.

3. **Present Position**

I consider large Boards (i.e. exceeding 8 members) undesirable in that they cannot respond quickly to the needs of the business. Boards with large numbers of directors are difficult to administer and, despite tele and video conferencing, are difficult to assemble at short notice.

I consider quarterly Board Meetings a waste of time, as the non-executives cannot begin to be up to date with developments in the business to make a useful contribution. Ideally, Boards should meet monthly as soon after the latest management accounts are to hand.

4. **Independence**

I consider that independent non-executives should always dominate the Board and that, of the executive team, only the Chief Executive, Finance Director and possibly one other should have Main Board status. This limited executive representation will militate against Board meetings digressing into a detailed review of operational (i.e. non strategic) issues.

Given the special role and status I consider it essential for the Chairman to achieve, I do not consider it practical or necessary for each non-executive to be expected to be or capable of fulfilling the Chairman's role.

All non-executive directors should be entirely independent, by which I mean: -

- Remunerated in cash only (i.e. no shares)
- Have no share price related or other incentives.
- Not hold office as a director (executive and/or non-executive for more than 6 years).
- Not be 'connected with' any shareholder or fund manager holding 0.5% or more of company's share capital or employee or other director of the company.
- Not hold 0.5% or more of the Company's share capital himself/herself (or family).
- Not be 'connected' with any of the Company's bankers, advisers, significant customers or significant service providers.

5. **Conflicts of Interest**

The main potential conflicts of interest that may arise within a company are:

- i) those simply relating to the independence of the non-executive or (more properly) conflicts arising from their non-independence;
- ii) excessive remuneration demands of the executives;
- iii) where the executives resist takeover or merger approaches for fear of losing their positions;
- iv) where there are conflicts of opinion over judgmental accounting matters that can potentially impact upon executive incentive arrangements;
- v) where there are disagreements over strategy potentially impacting executives incentive arrangements.

The first issue can be overcome by all non-executives being required to be independent.

The latter four issues can simply be overcome by the non-executives ensuring that they recognise the potential conflicts and, if need be, being sufficiently forceful to prevail over the executives and thereby fully protect shareholders' interests; by the non-executive being in the majority and by their having direct access to good external advice.

6. **Commitment**

As I consider that to be effective a non-executive should be available to attend monthly meetings and the Chairman and Committee Chairmen more often, I would suggest that a Chairman should not have more than 3 Chairmanships or 5 non-executive directorships of listed companies in total. A busy non-Chairman could manage 6 non-executive posts effectively. However, for the Chairman, the bigger the company, the fewer directorships he/she should hold and concomitantly, the more he/she should be paid for those he/she does hold.

7. **Senior Independent Non-executive**

Senior independent non-executives do have a limited role but only (in my view) where shareholders are critical of the Chairman and are concerned that, if communicated solely to the Chairman, this criticism may not be communicated by him/her to the rest of the Board with the same tone/frankness. The senior independent could easily be the

deputy chairman and experience as the senior independent should be a prerequisite for qualification as the Chairman of a public company.

8. **Statutory Duties**

Whilst I am not opposed to a statutory restatement of the legal and fiduciary duties of company directors, I question what is wrong with the current legal position. I would strongly oppose any attempts to broaden the fiduciary duties of company directors to extend to so-called non-shareholder “stakeholders”, such as employees, suppliers, the community at large etc. Directors require absolute clarity as to who they serve and the regularly recited “stakeholder” concept is directly opposed to maintaining that clarity. Directors currently only have fiduciary duties to shareholders. They may have statutory or contractual duties to others, but their fiduciary duty is paramount. A statutory statement affirming that directors’ sole fiduciary duty is to shareholders would be useful.

As I consider that Boards have collective responsibility I consider it entirely right that any proposed restatement of directors’ duties should not distinguish between executives and non-executives.

B. ATTRACTING AND APPOINTING NON-EXECUTIVES

9. **Key Skills**

The key knowledge essential for non-executive directors is an appreciation of their fiduciary duty to the company’s shareholders and of the corporate governance regime. This knowledge can easily be acquired through a one day course. Apart from this, non-executives should come with the widest range of experience (public and private sector), professional qualifications and interests as possible.

10. **Personal Qualities**

All personal qualities and attributes should be accommodated but non executives need to be comfortable with the commercial world. This does not mean that they can only come from the commercial world but that must subscribe to and identify with the commercial role of the companies they serve. Non-executives, as servants of the shareholders, must be prepared to advance the development and commercial success of the Company and to assist the executives to achieve this and should not consider themselves to be representatives of any particular interest groups..

11. **Mix of Attributes**

The Chairman should be experienced in relation to City issues, dealing with institutional shareholders and financial, broking and legal advisers. The remainder of the non-executives should contribute the widest range of experience and skills relevant to the company's business. Corporate governance "experts" with no other skills or experience are of little value.

12. **Recruitment**

It is progressively becoming more difficult to recruit suitable non-execs because the effort risk reward ratio has become completely out of balance. Successful business people/professionals are not interested to spend 12+ days per year, potentially risking their reputations and/or fortunes for £25-30,000 pa.

13. **Pool of Potential Non-executives**

Most Nomination Committees rely on head hunters to search for non-executives. My experience is that these head hunters have limited vision as to suitable candidates. Compulsory advertising for non-exec appointments (similar to local government posts) might encourage a broader selection.

14. **Rewards**

The rewards for non-executives are, in my view, completely out of step with the effort and risk involved. Smaller Boards should enable non-executive remuneration levels to be increased. Fees will increase if individuals are prevented from holding more than a fixed number of appointments. A number of non-executives of my acquaintance claim not to "do it for the money" but out of a sense of public duty. In my view this is the wrong motivation as it inclines non-executives to be overly cautious. Non-executives need to be calculated risk-takers and comfortable with the commercial world: - The notion that by paying non-executives well this will itself deter them from risking their non-executive positions by staying quiet on issues with which they are not comfortable is wrong. The potential damage to their personal reputations tends, in my experience, to be the prime motivation in difficult situations. It will only be weak non-executives who will be motivated by their fees and it is the job of Nominations Committees to ensure that such individuals are not appointed.

The maximum term of 6 years for non-executives that I propose should also militate against the 'jobsworth' mindset

15. **Indemnity and Insurance**

No-one should become a director (executive or non-executive) of any UK company, listed or non-listed, without an indemnity from the company concerned, together with a clear commitment for the Company to provide substantial D&O insurance cover for the duration of the appointment and six years thereafter.

C. **STRUCTURE AND ACCOUNTABILITY**

16. **The Combined Code**

My experience is that the Combined Code is working in practice, with the reported non-compliance disclosures seeming to reduce each year.

Apart from reducing executives' nominal notice periods, my assessment however is that the Combined Code has made very little difference to the corporate governance of listed companies other than reflecting what was already generally in practice.

Whilst it is difficult to generalise, my perception is that the balance between executives and non-executives has continued to work well, largely unaffected by the Combined Code.

As suggested above, all non-executives should be required to satisfy the above independence criteria.

17. **Board Structure**

Most well run companies had in place the structures recommended by the Combined Code before the Code recommended them. The key determinants of the effectiveness of the non-executives are their commitment and effort and the quality of information provided to them by the executives. These determinants are entirely in their hands and they would have no excuses at all if they were in the majority on any Board. For this reason I believe company law should be changed to require the Board of any listed Company to include a majority of non-executive directors (who should all be independent).

Board meeting procedures work as well as the Board wants them to work, in practice this depends upon the quality of the Chairman.

As suggested above, my experience indicates that Boards comprising more than 8 members are too unwieldy to be effective. Similarly, the number of executive directors on the Board should be kept to a minimum.

18. **Audit Committee**

My personal view is that Audit Committees are an impediment to the collective responsibility of Boards. They grew up as a response to the very large Boards of the “great and the good” still operated by a number of large companies, where many of the “great and the good” had no understanding of accounting matters and no inclination to learn. Such people should not have been appointed as non-executive directors in the first place. If Boards are kept small there is no reason why the entire Board should not deal with auditors, internal auditors etc in place of an Audit Committee. Speaking personally, I would be very uncomfortable to be a non-executive not on the Audit Committee, even though the Committee’s papers, minutes etc would normally be made available to non-committee members. As an executive director, I always insist on attending Audit Committee meetings even though I am not a committee member.

My view is that such is the importance of the Company’s accounts to the understanding of the Company by its shareholders and the market, direct dealings with auditors etc are too important to be delegated to a Committee.

To conclude, I would dispense with Audit Committee and require all directors to sign the Company’s statutory accounts (rather than the ludicrous US innovation of requiring the CEO alone to attest to their accuracy). This simple but symbolic device would, I am sure, act a a ‘wake-up’ call to some non-executives (even though they approve the signing of the statutory accounts). A former Chairman I worked with in the 1980’s required all directors to sign and initial every page of the Companies House filing copies of the Report and Accounts and every circular and I am certain that this engendered a greater sense of personal responsibility for their content and accuracy.

19. **Nomination Committees**

Apart from needing to recruit non-executives from a wider constituency, I have few issues with the working of such committees.

Remuneration Committees

Working properly, the role of remuneration committees should be to consider advice on and, in conjunction with its advisers, to devise remuneration structures for recommendation and adoption by the Board as a whole. Accordingly, the Board as a whole should be accountable for its remuneration policy and decisions – not the Committee.

Certainly, the remuneration committee should consist entirely of independent non-executives and should directly retain remuneration and benefits advisers and deal with such advisers directly on terms of confidentiality (i.e. the advisers should not have direct contact or other relationships with the Company). In all probability this will increase the workload of the non-executives and will need to be reflected in their remuneration.

20. **Objectives**

The Board's performance as a whole can only be measured against its achievement of progress (in shareholder value terms) in delivery of its publicly stated strategy.

21. **Measurement**

Measurement of the performance of individual directors (as directors) is, in my view, neither practical nor desirable. Any director performing inadequately should be dealt with by the Board. If the Board fails to deal with an inadequately performing director, it is accountable to shareholders. Shareholders can also (without giving any reason) simply vote against any director's reappointment when next he/she comes up for re-election.

The performance of individual executive directors in his/her executive role, is typically assessed through their short-term and longer term incentives devised and implemented by the rest of the Board. Provided the performance criteria is consistent with the Company's stated strategy, I see no reason why, as with all the other terms of directors' employment contracts, the performance criteria against which individual director's performance is measured should not be published. This can be devised in such a way as not to compromise any commercially or price sensitive projects or internal targets.

As to current proposals to require companies to provide charts showing the company's performance compared with various indices, I am relaxed on this provided that the same indices are shown by all companies and, possibly the FTSE sub-sector for the company concerned.

The performance of non-executive directors is no different from that of the Board as a whole. The entire Board has collective responsibility for its performance.

22. **Challenging Executive Decisions**

Non-executives who fail to challenge actions or decisions of the executives with which they are not comfortable are in dereliction of their duty. Non-executives are always able to challenge decisions of the executives and have the ultimate power of resignation if not

satisfied, with all the publicity this normally attracts. Typically, it seldom necessitates resignation, but non-executives should not shrink from resigning if they feel strongly about an issue. I do not consider that, apart from revising company law for listed companies to ensure that independent non-executives are a majority, any additional powers are required to assist non-executives to do their duty.

D. RELATIONSHIPS WITH SHAREHOLDERS

23. Improving Relations

I can only comment from personal experience and am of the view that, apart from the Chairman, few non-executives have much of a relationship with the Company's specific shareholders. They may have social or professional relationships with certain shareholders who, coincidentally, are the Company's shareholders. Increasingly the trend is for institutional shareholders only to want to deal with the Chief Executive and Finance Director. Some cultivate relationships with Chairmen to raise issues of corporate governance.

My view is that, apart from the senior independent non-executive being encouraged to establish relationships with shareholders (in addition to the Chairman), it is not necessary for every non-executive to do so. In coming to this view, I assume that the company's broker(s) provide regular feedback in written reports to the Board on shareholders' views on the Company and its management. This is an essential function of the Company's broker(s) and they have a responsibility to be completely frank in their reports, regardless of any relationship they might have with the Company's management. It is important that the brokers can speak freely and, again, this climate has to be promoted/cultivated by the Chairman. I am opposed to the proposal that the non-executives should have an annual private meeting with a company's shareholders. If such meetings were open to all shareholders, as I consider they would have to be, there is a danger that they would duplicate the Annual General Meeting, which, notoriously, most major institutions do not attend. Secondly, why exclude the executives, if shareholders have something to say they should do so openly.

24. Role of Chairman

The extent to which Chairmen create the conditions for the other non-executives to be effective depends entirely upon the quality of the Chairman concerned, hence the paramount importance I attach to the quality of the Chairman.

25. Relations between Non-executives and Executives

All directors of a company should work together. The non-executives should feel that they can telephone/meet any of the executive directors

at any time to discuss any aspect of the Company's affairs. Similarly, they should be free to and avail themselves of the freedom to directly contact the Company Secretary and his/her staff. In addition, through the Chief Executive, non-executives should be entitled to request meetings with senior finance personnel, internal audit, safety managers, and senior divisional management to discuss any matter. The non-executives should also be free to make direct contact with the Company's brokers, financial advisers, auditors and lawyers to seek any information they reasonably require.

26. **Role of Company Secretary**

The Company Secretary has an important role in ensuring that the non-executives are kept informed of developments within the Company, ensuring that they receive regular comprehensive reports on key areas within the Company (usually in the form of Board packs distributed in advance of Board Meetings) and generally acting as a reference point within the Company.

In relation to his/her duties of servicing the Board and the non-executives in particular, the Company Secretary's contract of employment/terms of reference should clearly establish that he/she reports directly to the Chairman (as apposed to the Chief Executive or other executive director). The Chairman should encourage a climate where the Company Secretary considers he will be supported in any dispute with the Chief Executive over any information the Secretary properly considers the non-executives should receive.

The Company Secretary has an important role in providing advice to the non-executives on matters of corporate governance, in addition to the secretarial affairs of the Company. It is important that the Secretary establishes a working relationship of trust with both the non-executives and executives and retains a measure of independence from the executive management. Apart from the personal skills and qualities of the Secretary, the cultivation of a climate conducive to this balance is another of the Chairman's many tasks.

E. **SUPPORT**

27. **Access to Information**

In my experience non-executives secure access to all information they seek. Some seek more than others. It is for the non-executives to decide how much information they require and then for them to ensure that they get it.

28. **Training**

Non-executives should undergo formal training in their legal and fiduciary duties and corporate governance responsibilities before being

appointed and thereafter attend refreshers at two yearly intervals or so. More specialised courses could be organised by the professional firms, tailored to specific issues and sizes of company. Of the courses I have attended, I have invariably found them too broad in scope to provide anything other than the most basic information.

29. **Induction**

Induction for non-executives can always be improved. Essentially, it is a matter of the time they can reasonably be expected to devote in relation to their remuneration for the job. If remuneration levels are substantially increased as I advocate, then the time required for induction and training can reasonably be increased.

30. **Guidance**

My experience is that non-executives receive clear guidance on what is expected of them and pretty clear feedback from their board colleagues if they are wanting. Again this depends upon the professionalism and personal skills of the Chairman.

F. SMALLER LISTED COMPANIES

31. **Different Provisions**

In many cases smaller listed companies need more committed and professional non-executives than larger (assumed longer established) companies. The difficulty is that, generally, smaller listed companies are less able to afford high calibre non-executives and 'first division' advisers. I am convinced however that there should be no dispensation or relaxation of Board's duties or corporate governance standards for smaller listed companies. As with the other costs concomitant with acquiring a listing, the cost of complying fully with corporate governance standards should be seen as the price to be paid for access to capital markets.

G. INTERNATIONAL CONTEXT

32. I do not favour the 'two tier' Board structure. As in my experience, the members of the 'supervisory' Board are too remote from and too slow to react to the needs of the business. In many Continental European examples, Supervisory Board members are seldom independent and often are specifically nominated to represent banks and other institutions and companies who are significant shareholders in the companies concerned.

In my view the most effective Boards are 'lean and mean' and comprised of professional non-executives who identify closely with the businesses they manage. Accordingly, I see two tier Boards as potentially divisive and generally inefficient.

I have little experience of other listed company Board structures, save in the Far East, where the non-executives are frequently nominated by specific large shareholders or banks and are far from independent.

CONCLUSION

Apart from minor structural changes such as requiring there to be a majority of independent non-executives; maximum term of 6 years; requiring all directors to sign the annual report and accounts; limiting the number of directorships individuals hold; requiring all Chairmen to have had experience as a senior-independent prior to being eligible for appointed as Chairman and significantly improving the pay and status of non-executives, I do not see much wrong with the current arrangements.

Non-executives and executives who are not happy with the affairs of the companies they manage, already have all the powers they need to challenge such issues. As a last resort, public resignations are a powerful tool. Significant increases in pay and a reduced number of appointments should encourage greater commitment and a more professional cadre. Individual directors (non-executive and executive) must earn their pay.

Yours sincerely,

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