

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

Memorandum from Sir Nigel Mobbs – Chairman, Slough Estates Plc.

1. Introduction

- 1.1 This memorandum is based upon my 40 years experience as both an executive and non-executive director of a number of different listed companies. I have also been a chairman of listed companies for over 25 years.
- 1.2 During this time, I have faced a number of significant corporate governance challenges which are relevant to the current review.
- 1.3 I have also been a member of the Hampel Committee and for 7 years I was chairman of the Institute of Directors Professional Standards Committee.

2. Role

- 2.1. The unitary board comprising a balance of executive and non-executive directors is a good model. It provides for good checks and balances and, as a result of recent reports on corporate governance, best practice is emerging and is adopted by most listed businesses. For this reason the more bizarre behaviour of a minority of US companies is now less likely to occur in Britain. Current board conduct is generally good and the last thing that is needed is interventionist regulation, though some improvements in best practice may be appropriate to strengthen the authority of the board in dealing with remuneration and audit matters.

2.2 The board of directors should provide –

- ◆ entrepreneurial leadership which drives the performance and progress of the business, and
- ◆ prudent control,

a duality of role which needs to be effectively managed in the interests of the shareholders.

First, the leadership of the business should drive forward the strategic planning of the business for management to implement. The board needs to ensure that innovation and fresh thinking is injected into the business and they need to support the ideas emerging from the management team. Enterprise will create prosperity and the board has to be conscious that business involves risk; and that risk needs to be effectively assessed and managed.

The other side of the coin is that the board of directors controls the business in a prudent way. In doing this, they test management's ideas, they measure performance – if possible against industry benchmarks – and they create a culture that observes good governance and control practices.

The board must avoid managing the business that is the responsibility of the executive directors but the board should establish the values and set standards.

2.3 The role and influence of the chairman is crucial. Cadbury described the chairman's role as follows:-

"Chairmen are primarily responsible for the working of the board, for the balance of its membership subject to board and shareholders' approval, and for ensuring that all directors, executive and non-executive alike, are enabled to play their full part in its activities."

The chairman has a focal responsibility which ensures that the values and standards set by the board are applied, that the agendas of meetings are relevant and effective and that the appropriate financial and management information is available on a timely basis to all directors.

The chairman fulfils an important role in being a bridge between the executive and other members of the board.

- 2.4 Within a unitary board, all directors share equal responsibility in law. But in practice non-executive directors do have a different and distinct role. They are there not only to provide a diversity of relevant experience to the business but also to monitor the activities of the management team. They need to be independent in spirit and have an inquisitive mind. They must be rugged and rigorous in their approach to problems and challenges.

The presence of non-executive directors on boards provides a useful and at times an essential check against executive managements that may be deaf, insensitive or arrogant to the interests of shareholders.

The role of the non-executive director is different to that of the executive but it should be one which can be fulfilled within a spirit of partnership and mutual respect. The non-executive director has a patrolling influence. He can bring a wider strategic perspective and business experience to boards. The presence of non-executive directors encourages good discipline and housekeeping within boards and it can bring an independent and more dispassionate view on the way in which key decisions are taken and conflicts resolved.

But if a non-executive director is to fulfil his role, he must feel that he is working both alongside and with the executive and that his opinions are trusted as being supportive of the corporate ethos rather than being seen as an alien policing influence in the boardroom. Non-executive directors

should encourage enterprise and they should challenge the objectives and assumptions. Only in extreme circumstances should non-executive directors enforce their power and influence over the executive and that is only when the executive have failed the owners by disregarding their interests or have failed consistently to meet ownership performance and conduct expectations.

- 2.5 Independence is a term that is not capable of easy definition. The NAPF apply a list of criteria by which independence can be judged but these criteria are not universally applicable. For example, diligent and inquisitive directors do not lose their independence merely by length of service. Hence a 3 x 3 year term can be over-restrictive and companies can be forced to lose valuable continuity of knowledge. Rather than using the term "independence" the test should be one of "objectivity" which is more about state of mind and the manner in which a good non-executive director functions. A good objective and independent director should clearly be free of significant conflicts of interest, should be financially self-sufficient and have moral courage to stand up for his or her opinion and judgement. I would urge the Review to reject the over-simplistic tests commonly adopted by the shareholders' watchdogs and recognize the test of objectivity.
- 2.6 Conflicts of interest in the board can be managed if the chairman and other members are aware of each member's interests and the risk of conflict can be assessed and managed. Clearly there are well-known areas of conflict such as cross-shareholding, significant business relationships etc. Boards should adopt strong standards of transparency and ethical behaviour and in extreme cases directors may have to resign if the conflict is too great. However, there are many lesser ways of reconciling conflicts by withdrawal from discussion, temporary exclusion from information, etc. The greatest area of conflict between executive and non-executive directors is over compensation, audit and accountancy issues and terms of employment. This is why it is important that there are appropriate committees comprising non-executive directors to deal with such issues.

- 2.7 The allocation of time varies enormously according to the nature of the business, its product and global reach and the relevance of external regulation. All non-executive directors should be willing to commit as much time as is required to both “on and off the job” work to enable them to fulfil their role in an effective, diligent and well-prepared manner. It is for the chairman to assess whether individual directors do meet these three tests.
- 2.8 There should be no prescriptive limits as to the number of non-executive posts that any one person can sensibly take on. It depends upon the overall workload, the nature of the appointments and the time available. For a working chief executive, two or three non-executive appointments might well be sufficient. Many companies do impose such limits. In determining sensible guidance, it is also important to include non-corporate involvement such as appointments to charities, government agencies and trade associations. I believe that there should be an understanding between the chairman and the director as to his or her ability to undertake their responsibilities in a diligent and committed manner whilst at the same time meeting the demands of other appointments. Non-executive directors are appointed for their wider experience and to impose a proscribed maximum number of appointments might inhibit such qualities.
- 2.9 I am supportive of the role of the “senior independent” non-executive director. Such a person provides a focus for the non-executives where occasionally the need arises (but the “senior independent” should exercise care that he does not without due reason usurp the proper role of the chairman). I have in the past acted both as the defined “senior independent” and at times informally. My experience suggests that an identified role, possibly as a deputy chairman, eases the situation. The “senior independent” can also act as a point of contact for concerned investors and can be a natural focal point for the non-executives and executives in unusual circumstances.

The key factor is that the “senior independent” director has to be sensitive to the role and not become a catalyst for revolution. He needs to be conscious of the opinions of both executive and non-executive board members and, if problems are emerging, discreetly brief the chairman and maybe the chief executive. He should also be available to shareholders if they have reason for concern which contact through the normal channels has failed to resolve.

3. Attracting and Appointing Non-Executives

- 3.1 A board should have a broad spectrum of financial, business, technical and political experience relevant to the business. Experience could be gained in the corporate world or public sector including government and academia. Candidates need to be familiar with sound corporate governance and responsibility and be comfortable with organizational challenges. A good board is made up of a range of complementary skills and experience. Good directors should be diligent, inquisitive and mature in outlook. Above all they need to be team players and respectful of other opinions.
- 3.2 General experience of corporate and organizational life is important in solving board issues and in scrutinizing performance and behaviour.
- 3.3 The greatest deterrents to people accepting new directorships are:-
 - (a) Pressure on candidates in their principal place of work.
 - (b) Fear of being associated with improperly managed companies and the personal liability associated with corporate failures arising from bad practice and lack of necessary financial and management disciplines.
 - (c) Unreasonable responsibilities or expectations of government, regulators and the media.

It is not a problem of whether people can be attracted, rather it is that the role has become more onerous and risky.

3.4 Clearly a wider spectrum of talent needs to be attracted but in order to do so the increasing exposure of non-executives needs to be contained. More businesses should be encouraged to allow emerging talent to become involved in other businesses, despite an increasing risk of conflict of interests. International representation on UK boards is a possibility for those companies with an international dimension. But no international director can necessarily devote sufficient time to meetings in the UK. He or she may not be familiar with the corporate culture and conventions of UK business and their general experience may not be wholly relevant.

3.5 It is difficult to assess what is a proper rate of remuneration for the workload and risks involved. By way of some basic principles, I believe that:-

- (a) The level of remuneration should not result in a non-executive's lifestyle being dependant on remuneration from any individual non-executive appointment.
- (b) The non-executive should, whilst associating himself with the shareholders' interests, maintain freedom of involvement to act at all times in the best interests of the whole company.
- (c) A significant level of remuneration in shares could create conflicts and loss of independence.
- (d) Significant payment in shares will reduce the availability of directors from a wider field and could result in only the "fat cats" of the corporate world being available.
- (e) The level of remuneration should be assessed as to the likely workload, the complexity of the business, the level of remuneration prevalent within the business sector and the risks involved.

In summary, current non-executive fees are light by North American comparisons and probably on a job evaluation basis light by pro rata

comparison with equivalent executive pay rates. However, by adopting the principles above, the fees of non-executive directors are not greatly out of balance.

- 3.6 Risk and the consequent exposure to action for mismanagement is increasingly a deterrent to attracting new non-executive directors. Clearly nobody will condone gross negligence or illegal behaviour but it is questionable whether current Directors and Officer liability insurance cover is robust enough to provide protection against today's thirst for litigation.

4. Structure and Accountability

- 4.1 In my experience responsible, well-led companies respect the Combined Code and its fundamental principles are influencing the adoption of best practice. The balance between executive directors and their independent non-executive counterparts is about right. No further definition of independence is needed; the guidelines exist and companies should interpret them in an objective and practical way rather than by strict adherence to rigid definitions. It may well be helpful if companies were encouraged to publish their own interpretation on the application of the Code and to highlight and justify any variances from it. (Attached as Annex A are the current guidelines adopted by Slough Estates).
- 4.2 Current good practice encourages specific board committees, eg: audit, remuneration and nomination. As a result of emerging need, there may be a need for a greater scrutiny of environmental, social responsibility and ethical issues through the board committee structure.
- 4.3 Generally the roles for audit committees are effective and do not require change though increasing regulation of different businesses might require added scrutiny of compliance. There is some scope for reinforced terms of reference to ensure that audit committees should pay more attention to the identification, assessment and management of financial, operational and reputational risk. The committee should also be solely responsible for assessing the performance of external and internal auditors and for recommending their appointment or removal. They

should also scrutinize additional work undertaken by the auditors to ensure that the auditors' independence is maintained. It might also be appropriate for each annual report to contain a specific report from the audit committee on its work.

- 4.4 Changing rules are also reinforcing the relevance of the remuneration committee with a vote on the remuneration report and its enhanced content. Only time will tell whether these changes will result in a better understanding of remuneration issues. What is clear is that if there is further intrusion into the private affairs of directors, many senior executives in the future may opt not to be appointed directors, so weakening board balance.
- 4.5 Board size should be determined by the nature of the business, the size and composition of the executive team and the range, experience and skills of the non-executives. It is important to appreciate that often the best non-executive directors are those who are busiest and in the interest of intensified scrutiny of corporate governance, there should be sufficient non-executives to participate in the increasing volume of board committee work needed.
- 4.6 The quality of board meeting procedures is very dependant upon the leadership and involvement of the chairman together with the availability of quality management and financial information presented in a timely and consistent manner. There is a real threat that some executive managements believe that quantity is a substitute for quality and that consequently directors become deluged by irrelevant information that dilutes the effective working of the board. Generally boards are having to give much more attention to the definition, assessment and management of a range of risks including reputational issues.
- 4.7 I am wary of creating any mechanisms for measuring board performance. The very basis of a board is to manage the business in a responsible way to enhance the shareholders' investment. This is a key performance indicator which is a sufficiently transparent measure provided that the outturns do conform to good accounting and

management practice. The board should be judged as a collective unit rather than highlighting the strengths and weaknesses of individuals. It is for the chairman to consider in private whether individual board members may be weak in their contribution and to deal with the consequences if appropriate. Despite these comments, it is always important that boards should be vigilant to weaknesses in their stewardship and take the appropriate remedial action before others force the issue.

5. Relationships with Shareholders and Others

5.1 Relationships between the company and shareholders should be the responsibility of the chairman and chief executive. They in turn should ensure that the board be made aware of any concerns that exist. I do not support the idea that there should be regular communication as between the non-executive directors and shareholders because:

- (a) Such programmes could be divisive of board unity.
- (b) It imposes increased time and management burdens on to the non-executive director.
- (c) Non-executive directors lack the detailed familiarity with the business except for certain strategic areas.

There is no general relationship between the board and shareholders and such contact as there is should be channelled through the chairman or, in special cases of concern, through the identified "senior independent" non-executive director.

Another factor is that many institutional shareholders lack the management experience and analytical skills to embark upon a widespread programme of additional contact.

5.2 The role of the chairman is of critical importance in overseeing good corporate governance, the management of the board and for ensuring constructive discussion and harmony within the board. The chairman

should maintain close interest in investor relations and more generally the company's reputation with other stakeholders.

- 5.3 A unitary board should be based upon mutual trust and respect between all directors. One of my non-executive colleagues described the relationship as follows:

"I see the executive directors as close professional colleagues. We should be willing to share all information and concerns in a constructive way to the good of the company. I think we should be more distant from senior staff. If we are not, there is a risk we may become entrapped into executive matters. We should however know the senior members of the staff and display interest their work. They should feel able to talk to us if they believe they have a whistle to blow that cannot be handled in the usual way."

- 5.4 A good company secretary can play an important role in supporting and advising the chairman and board on issues of good practice, legislation and governance. In particular, the company secretary must be trusted by the non-executive directors to provide impartial and discreet advice.

6. Support

- 6.1 It is not practical to determine precise rules as to the flow of information needed as it will vary from business to business. There needs to be an availability of timely and consistent management and financial information to enable all directors to fulfil responsibilities determined by law, regulation and good practice. Information needs to be supported by presentations by the executives, senior managers and staff to improve overall familiarity with the business. The emphasis in all information flows should be clarity and transparency; quality rather than quantity. There is too often a real risk of data overload and too much reliance on technical language. The board through its chairman should determine what they require and the executive should be charged with providing it and, when asked, provide validation as to its accuracy, compliance with law and standards.

- 6.2 There is a growing emphasis on training. However, non-executive directors are usually already experienced directors on appointment. Many management schools and the IoD do provide useful courses to those who need more training. Participation in such courses should be encouraged. All new directors should receive a thorough induction course on appointment. The content of this should be monitored by the chairman to ensure that it provides a comprehensive briefing.
- 6.3 A new director's letter of appointment should define what is expected of him or her. It is the responsibility of the chairman to maintain a continuing dialogue with each non-executive director.

7. Conclusion

- 7.1 In general terms, non-executive directors do function effectively. Best practices suggest that there is a continuing process of improvement as the focus of good corporate governance intensifies. To create a framework of specific regulation on the role, qualifications and work of non-executive directors is more likely to deter involvement and will not necessarily result in behavioural improvement.
- 7.2 Consequently I would suggest that emphasis be given to promoting the improvement of mechanisms of good corporate governance and publicizing best practice.
- 7.3 The review should recognize the important role that the chairman plays in managing the business of the board, enhancing relationships between executive directors and ensuring the quality and veracity of financial management information.

Nigel Mobbs

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