

Response From Stephen M G Hodge

16th August 2002

I am a non-executive director of mmO2 plc and Chairman of its Audit Committee. Up until September last year I was Director of Finance and CFO of the Royal Dutch Shell Group, where I worked in various countries and various capacities since the 1960s. I am also Chairman of the Shell Pensions Trust, which is run by a board composed equally of elected employees and pensioners and Shell appointed members.

Over the years I have had a number of non-executive roles in companies partly owned by Shell, and of course have observed the Royal Dutch/Shell governance system close up from 1992 to 2001

My observations are as follows:

The role and independence of the Non-Executive Director ('NED') (relevant to your questions 1-8, 27-34)

There is a 'model' of the role of the NED which has it that the job is to turn up at a Board meeting once a quarter (having carefully studied the board papers), listen to management presentations, offer appropriate wise comments and ask wise questions, and then participate in the board decision. It is this model drives the continental two tier system of corporate governance, and also to some extent the (informal) US model of a board largely composed of NEDs. It is also a legalistic approach – and thus one to which the government and the civil service is naturally inclined.

This model - call it 'the traditional model' - is still well liked but has a limited view of the NED role, categorising it in terms of addressing those conflicts of interest of primary concern to institutional investors. I believe however it is seriously flawed

- ◆ It sets the management and in particular the CEO in natural opposition to the NEDs, and creates conditions for a contest which the NEDs are in almost every case doomed to lose.
- ◆ The NEDs should have little confidence in their ability to spot trouble or problems at an early stage, confined as they are to infrequent highly formal interactions with management
- ◆ Vital decision areas affecting the company's people - such as those around recruitment and termination reward morale and culture are excessively influenced by one or two executives and their paid advisers, with little capability for independent input from the board. This is particularly unsatisfactory given that the overriding imperative for most businesses today is attracting and retaining the best talent
- ◆ Being bureaucratic, it is fundamentally quite slow and ponderous, running at a

nineteenth century pace rather than one appropriate for today.

- ◆ It gives excessive weight to the concerns of institutional investors, because these are the only ones that the NED can realistically be expected to address

This is not the way to produce high performing businesses in the 21st century; nor one which will produce well informed input to the behaviour of the company genuinely independent of the management

What is missing in the traditional model is a recognition of the value of engagement with the business, its management and its people by the NEDs. What is needed is a group of NEDs who are engaged with the business and its management in several different ways, formal and informal, operating as team to ensure that the company achieves the best it can from its opportunity set. And NEDs who have knowledge in depth about the company - which can be gained only by a wide variety of interactions - will be far more capable of providing the effective independent check and balance that is an essential part of the role than one confined in infrequent highly formal interactions with topmost management

Unfortunately there is a tendency - perhaps in some cases a somewhat self serving tendency - to equate independence with disengagement which is a fundamental confusion of thinking. It is of course true that a High Court Judge is both independent and disengaged from the hopes and fears of the litigants, but this is not a relevant model for the role of an NED on a Plc board. To the contrary my strong belief is that an engaged NED can be independent while a disengaged NED will both struggle to make a worthwhile contribution and because of the paucity of his information sources may well be less than fully independent in practice

Although the NED role is a 'watchdog' role- because the NED is not part of the management and management must manage and take responsibility for its actions - it is not helpful to emphasise this aspect of the role to the detriment of the other aspects or to seek to define 'independence' much more precisely than it now is. It is in fact hard to imagine an NED worth recruiting to a Board who would be independent of all interest groups impacting on the company - he or she would be so disengaged as to be ineffective in all but the most extreme circumstances, by which time it is usually too late for the shareholders, employees and other stakeholders. Once the width of the problem is clear it also becomes clear how futile it is to try further define 'independence', or to categorise all the possible conflicts of interest that can arise

I would suggest that the way to proceed is to describe with greater richness the role of the NED, perhaps coupled with a rather limited set of rules which prescribe those cases where a NED clearly cannot be categorised as independent. The role description should be derived from the role of the Board and needs to address the contentious area of the role of the Board in relation to stakeholders other than institutional shareholders. Out of this I am sure could come a balanced statement of the role of the NEDs covering both the 'watchdog' role and the role as an engaged member of the leadership of the company

All of which has clear implications for the qualities and time commitment required from NEDs. They need to have capability to engage not just with the CEO but also

with the management below him or her, with mutual respect on both sides.

They need to have the personal sensitivity to be able to handle such contacts without undermining the leadership of the business, and they need to be able to play a full part in helping the CEO and his team shape the corporate culture and values they jointly believe are required for success in their business

The implications for time commitments are clear A minimum seems to me to be 25 to 40 days a year, and not concentrated in a single burst once a month, but including a variety of smaller less time consuming interaction which together add up to a significant time commitment. And there are implications also for age limits, and the number of NED positions it is realistic to hold

I would guess for smaller companies the need for an engaged board is well accepted. My view is that the same logic applies to even the largest companies

I would also add that I do not see any merit in a wholesale shift of UK corporate governance to either the European or the US model. The system we have in the UK works reasonably well, although it could work better, and there are a number of clear drawbacks to the rival systems, albeit that they also work, although mostly not as well overall as does the UK model. The costs and risks of change would far outweigh any possible gain

The Chairman, Senior Independent Director and communication with shareholders (your questions 23-25).

I support the principle that Chairman and CEO roles should be separated and believe that an executive role for the Chairman is only rarely justifiable. However if the Chairman is truly non-executive I cannot see the necessity for designating a senior independent director. The (non-executive) Chairman's role is to manage the relationship between the board and the management and also to act as a communications channel independent of the CEO for shareholders, and he or she should also be the conduit for NED pressure if difficulties arise.

Unfortunately this describes an ideal world and there are occasions when a Chairman described as non-executive is so closely aligned with management – perhaps for reasons of history, or personality - that a focus is needed for the NEDs. I think however that it was mistake to 'legislate' for this flawed situation by the senior independent director device. Better would have been a more robust insistence on a non-executive chairman, so that the need for a senior independent NED is positioned clearly as an (undesirable) stop gap solution

On the need for regular, formal channels of communication with institutional shareholders by NEDs and/or senior NEDs my view is that there is almost no merit in this proposal. This a role for the CEO and the Chairman, and I see absolutely no place for another mandated channel of communication. Moreover it seems to me to invite excessive attention to the wishes of vocal institutional shareholders. We should not automatically equate the interests of such shareholders with those of the company, its other shareholders and stakeholders.

There is of course, in the modern world, a great deal of communication from the companies to the shareholders, and this is wholly to be welcomed. Communication in the reverse direction - from shareholder to company - is rare and when it occurs may well be driven more by the particular interests and positions (sometimes obsessions) of the institution or its analysts than the interest of the company or the generality of its shareholders. Quite simply the NEDs should not usurp the role of the CEO, management and Chairman

And this objection of principle ignores the practical reality which such regular communication would involve – the last thing that the NED of the smaller company needs is to be required to attend a series of meetings with thirty year old portfolio managers (perhaps not even industry specialists) whose only interest is whether to go short or long of the stock before the end of the next quarterly measurement period, and whose views are often overly influenced by the back page of the Financial Times. There are after all many hundreds of listed companies, not many large institutions, and even fewer who would be prepared to field heavy weights at such a meeting

Liability, Insurance and Reward (your questions 12-14)

It seems obvious that in the unitary board concept there can be no distinction as regards liability between executive directors and non-executive directors, assuming always that liability is based on personal fault, such as the absence of due care, and is not some form of strict no fault liability imposed by virtue of holding a particular position

Equally obviously if large scale damages claims succeed – a la Equitable Life – which the directors are not felt to have brought upon themselves, the supply of NEDs (indeed possibly of executive directors) will dry up. There is no conceivable scale of compensation that could justify taking on exposures that could be measured in the millions

This is clearly a major problem if we wish to retain the unitary board, as I strongly believe we should - not least because my view of the role of the NED makes little sense except in the context of a unitary board

I can see no single solution, but it seems to me that there a number of policy responses which the authorities should pursue with vigour before the situation gets out of hand

- ◆ There should be no unnecessary barriers to Directors and Officers Liability Insurance ('D&O') being available and being paid for by the companies (there have been some legal issues in the past). It should quite clear to all concerned that D&O cover is legitimate and a necessary cost for business and those who provide it perform a public service
- ◆ The Lord Chancellor should be extremely cautious about changes to the legal system (whether it be in respect of jury trials, contingent fees or class action

rules) which make speculative litigation for astronomical sums of money an attractive business proposition for entrepreneurial lawyers

In parenthesis I would also observe that a culture of speculative litigation - as in the USA and increasingly in this country - tends to affect corporate governance in subtle and undesirable ways. One of the best controls on management excess is the practice that requires comprehensive and fully documented proposals to be prepared in respect of major decisions addressing specifically all identified risks. In a litigation culture such papers tend to get 'sanitised' or even suppressed by the corporate lawyers for fear of later legal discovery; and excess reliance is placed on oral presentations by the promoters of the proposal; all of which gives great scope to management to 'bounce' the board into decision or even to mislead if they so desire.

As to whether NED fees are in general too high or too low I express no strong opinion. I estimate that the most common fee level is about £30,000 per annum which for a successful business man or woman is not in itself a strong incentive to take on the role even now; but might well be for other types of candidate. There are signs that the going rate is moving upwards to perhaps £50,000 per year for larger companies. I cannot myself see that this is likely to materially increase the supply of business people, and would seem over generous to many. I suspect that the pressure to increase fees is actually a function of the rather small pool of people among whom the head hunters fish for NEDs. If, as discussed below, greater diversity could be achieved the pressure might reduce

More diversity among NEDs (your questions 9-15)

Best practice with NED appointments these days seems to require the use of 'head hunters', who naturally seek candidates from the same population as they seek candidates for executive positions. As a result it is not surprising that NED short lists tend to look rather similar in the type of people they include as executive short lists.

Driving all of this is the influence of the business press and the institutional investors who are more likely to be impressed by the recruitment of a successful respected businessman than, say, the headmistress of a large school or a senior scientist or academic. It seems to me that this attitude too has its roots in the traditional model for an NED described above, and is yet another aspect of the view that the role of the NED is primarily to address issues of conflict of interest of concern to institutional investors

Change in this mindset can only be achieved by persuasive statements which lead to a change in accepted best practice. Several initiatives could help - clearer statements of what is expected of NEDs (not, for example focussing on the idea that the main role of the NEDs is be a conduit to the City), emphasis on the need to engage with the business and its management and to contribute to the corporate culture would reduce the perceived attraction of the existing pool

But it is necessary to recognise that there are limits to the pursuit of diversity. For example:-

- ◆ it may not be easy for NEDs without experience of the corporate board

environment to make an immediate full contribution,

- ◆ some roles for NEDs do require specialist experience – for example the leadership of an audit committee;;
- ◆ there is perhaps a greater danger of diverse NEDs positioning themselves as the representative some special interest group – which is perhaps normal outside the corporate environment, but very inimical to a well functioning unitary board.

All of which suggests that regulation is inappropriate (i.e. impossible to draft) and also that NEDs should be expected to bring a variety of skills and experiences to the Board which should be used as appropriate.

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