

**The Role and Effectiveness of Non-Executive Directors**  
**Submission by Hugh Stevenson**

1. This memorandum is submitted in response to the Consultation Paper dated 7<sup>th</sup> June, 2002.

The views expressed below are based on my experience:-

- (i) as a director (both executive and non-executive), and in some cases chairman, of a number of public and private companies; and
- (ii) as the chairman, between 1992 and 1998, of a major institutional shareholder.

The opinions and conclusions contained in this memorandum are my own and should not be attributed in any way to the various organisations with which I am currently associated. In relation to the legal content of this note, I am greatly indebted to Giles Ridley, formerly a partner in Slaughter and May and now one of my senior colleagues at Equitas.

2. The essential elements of the role of the non-executive director were identified by the Cadbury Committee in the paragraphs quoted on pages 3 and 4 of the Consultation Paper. It is obvious that the two 'particularly important contributions' noted by the Cadbury Committee:-

- (i) to review the performance of the board and the executive and, by implication, to make changes to the executive if need be, and
- (ii) to deal with issues where the executive has an inevitable conflict (for example, the level of executive remuneration),

are fundamental not just to the proper governance of the particular company concerned but also to the workings of business as a whole. Unless someone performs these roles, the system cannot operate efficiently.

3. It matters that these functions should be carried out by independent non-executive directors of experience, calibre and integrity and that everything should be done to encourage suitable people to put themselves forward. This is particularly important because there is no one else who can effectively perform these roles. The only other possible candidates – the company's major institutional shareholders - have neither the time nor the skills for the purpose; their first obligation is to their clients or policyholders and in many cases they may have a conflict of interest because of some commercial relationship with the company concerned.

4. But there is a limit to the contribution that non-executive directors can make and there is a danger that too much may be expected of them. The business of many companies has become so vast and complex and the imbalance between the time, knowledge and resources available to the executive directors on the one hand and the non-executives on the other is so great that in the case of most companies non-executive directors cannot reasonably be expected to master all the details and technicalities of the business or have an infallible prescience of when things are about to go wrong. Non-executive directors can help to formulate the company's strategy and they can act as sounding boards and advisors, but there is only so much that they can contribute beyond the basic functions identified by the Cadbury Committee and the discharge of the responsibilities relating to Accountability and Audit set out in the Combined Code.
5. I share the general view that the Combined Code published in June 1998 is an excellent document – short, clear and sensible – and that the Code has worked well. But a framework is only as good as the people who operate it and, unless certain changes are made, the present corporate governance arrangements established by the Code are likely to become increasingly unsustainable.

This is not because of any inherent defects in the Code itself but because of:-

- (i) the growth of expectations that non-executive directors should play a role which they are not in a position to fulfil;
- (ii) the growth of a 'blame culture' in the UK;
- (iii) the lack of a statutory statement of directors' responsibilities (a point recognised by the Company Law Steering Group); and
- (iv) the lack of appropriate protection of non-executive directors under UK law against personal liability.

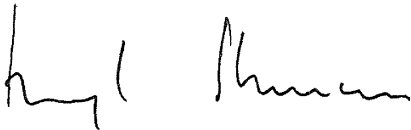
The position has become even more unstable in recent months because of:-

- (i) the litigation against the directors (including the non-executive directors) of the Equitable Life; and
- (ii) the sharp rise in the cost of Directors' and Officers' liability cover (assuming that the required levels of cover are obtainable at all).

6. Most non-executive directors do not understand how exposed they are. In the event that a claim is brought against them, there are only three resources to which they can turn - the company of which they are directors, their insurers and their personal assets. Section 310 of the Companies Act severely restricts the powers of companies to offer indemnities to directors. (The protection afforded to directors in the UK falls short of that available in most states in the USA). Although most companies take out Directors' and Officers' liability insurance, the small print of the policy may well restrict the cover to a far greater

extent than many directors assume. If the company and its insurers cannot or do not contribute to their costs and liabilities, the only alternative is the directors' personal assets and in the last resort, his or her personal bankruptcy.

7. This has not mattered in the past because litigation involving boards of directors in the UK has been negligible. But the landscape is changing. There is now a grave risk that suitable people will no longer put themselves forward as non-executive directors. It will be widely perceived that in the circumstances outlined above the risks of a non-executive directorship are completely out of line with the rewards. There is also the further risk that those who do serve as non-executive directors will adopt an excessively cautious approach, not only in relation to their personal position but also in relation to decisions taken by the boards of which they are members.
8. The following is needed as soon as practicable:-
  - (i) a statutory statement of directors' responsibilities;
  - (ii) the recognition that the sanctions for non-executive directors should be of a reputational, rather than a legal, nature;
  - (iii) the establishment of a legal standard of care which exempts the non-executive director from liability where he or she has acted honestly and in good faith and free from personal profits.
9. I strongly urge that the Higgs' Report should recommend accordingly.



**Hugh Stevenson**  
29<sup>th</sup> August 2002