

The Unquoted Companies' Group

Founded in 1968 to study the contribution made to the economy by the unquoted sector

Date:

05 September 2002

Mr Derek Higgs
Non-Executive Directors Review
Department of Trade and Industry
Room 2142
1 Victoria Street
London SW1H 0ET

Dear Mr Higgs

Review of the role and effectiveness of Non-Executive Directors (NEDs)

I am writing to respond to your Consultation Paper dated 7 June 2002 on the above subject. The Unquoted Companies' Group comprises an informal association of some 35 substantial unquoted family companies in the UK, many of whom have been in existence for several generations. Annual sales turnover of member companies range from £20 million to more than £1 billion. In an appendix to this letter I set out the characteristics of our member companies to assist your understanding of our constituency.

It is appreciated that the report which you will ultimately produce will have a substantial focus on listed companies. However we believe that Non-Executive Directors have a particularly important role to play in larger unquoted family owned companies and that this role differs in a number of important respects from the corresponding role in listed companies. Our members therefore consider that it would be helpful to you to respond to the Consultation Paper from the viewpoint of the larger unquoted family company, with our normally longer time horizons.

I set out in the sections which follow our responses to your five key questions. Throughout I use the abbreviation “NED” to refer to Non-Executive Directors.

A. What role should NEDs perform and how does this compare to the present position?

- 1.1 The board of a larger unquoted family company may comprise:
 - Executive Directors drawn from the family
 - Professional Executive Directors
 - Non-Executive family directors representing minority holdings
 - One or more NEDs not being family members
- 1.2 Unquoted family companies are much less concerned with short-term issues (such as the management of performance to meet market aspirations) than listed companies. The emphasis is more on the long-term maximization of viability in the chosen markets served by the company concerned. It follows that the primary emphasis for NEDs is to assist the board in formulating a strategically long-term view of the business and its opportunities. Without in any way belittling the contribution of NEDs who are also family members it may often be the case that the family board members as a whole may not possess wider business experience outside the confines of the company. There is therefore a particular role for the external NED who can bring a wider business experience to the board.
- 1.3 In a family owned company the NED, for obvious reasons, does not normally have to give the same degree of emphasis to the shareholders’ interests as in a public company. Nonetheless, since it must be right that a private company should aspire to similar standards of governance as a listed company, the NED in a private company should be there to provide exactly the same checks to ensure that the Executive Directors are acting in the best interests of the long term needs of the company, whilst also sharing with the Executive Directors the responsibility for the direction and management of the company within a strategy agreed by the owners and board. This may well mean that the NEDs’ main task is to reconcile and synthesize the interests of the owners and of the Executive Directors.
- 1.4 Apart from these considerations, it may also be important for the NEDs to temper the dominant role of a controlling family director/shareholder and bring some balance to discussions at board level. Sometimes, funders/banks may draw comfort from this moderating influence.
- 1.5 We believe that NEDs external to the family and having the requisite wide business experience have a particularly important contribution to make, as set out above. We therefore believe that major private companies should seek to recruit NEDs who have the right qualifications and experience to add breadth and balance and strategic insight to board considerations.

B. What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to NED roles?

2.1 The NED plainly has to have sufficient experience and the right personal and intellectual qualities to be able to understand the core aspects of the business and to establish a relationship of trust with both owners and Executive Directors. The qualities that NEDs should bring to a private company are exactly the same as would be required for a NED in a public company – a readiness to commit personally, wisdom and judgment which allows them to participate in the supervision of the company with both understanding and objectivity; and the strength of mind to be able to set and apply best standards of policy and decision making.

In addition to this:

- The NED whilst retaining his independence does need to be regarded as part of the team rather than as an outsider.
- He/she needs to have the ability to work with family shareholders who potentially, but not in all cases, may have relatively little business experience.
- He/she needs to have the ability to understand the internal dynamics of a family business.
- He/she needs to be able if required to act as a mentor to the Chief Executive and the board.

Ideally a large family company needs a group of NEDs who all have these general qualities but are also drawn from a range of different backgrounds such that the board can be given a wider framework in which to operate.

2.2 We regard it as important that the NED does not try to involve himself/herself in the business to such an extent that there is any blurring between his/her responsibilities and those of the Executive Directors. This is important to avoid compromising the necessarily limited measure of independence from the Executive Directors which is needed to function properly in a NED role.

2.3 The best NEDs will be attracted by a business which is intrinsically interesting and challenging and which is “going places” or has that potential. However the following features are of considerable importance:

- It must be clear to the prospective NED that he can make a valued contribution.

- The NED will often need to be satisfied that he/she can be concerned purely with strategic and other issues affecting the business rather than family issues. It is very desirable that family issues should be dealt with by a Shareholders' Council separately from the board.
 - Finally the recruitment of suitable NEDs will be much facilitated if the perception is that they will be working with congenial colleagues who are operating as a team with shared values.
- 2.4 We do not believe that remuneration should be a major factor in attracting NEDs of the right quality. Clearly remuneration needs to be adequate and reasonable but we are concerned that if remuneration is excessively high then the independence of the NED may be compromised.

C. *Do existing structures and procedures facilitate effective performance by NEDs?*

- 3.1 The procedures and structures which are encapsulated in the Combined Code probably do not need further elaboration in any significant way and are as relevant to large private family companies as much as they are to listed companies. However these procedures can only be used effectively if the NED can obtain the right level of information, both as regards quality and quantity. The NED needs to have a sufficient understanding of the business to be able to satisfy himself/herself that information he/she receives from the Executives is likely to be correct information. We believe that NEDs must be prepared to work hard to get the right level of knowledge and information and this is as true in a private family company as it is in a listed company of any size. The responsibility to have the right level of knowledge and information is most extreme where the NED is chairing an Audit Committee. It will also be of considerable importance where NEDs sit on Remuneration or Nominations Committees where the NEDs concerned must have sufficient knowledge of the senior executive staff whose promotions and remunerations they are considering to judge whether recommendations put to them are fair and equitable.
- 3.2 Apart from the critical importance of ensuring the right degree of knowledge and the right flow of information, the other weakness in existing structures and procedures relates to the degree of independence of the NED concerned. As with knowledge and information this is by no means an issue in all cases. However there is a concern arising from the operation of what might be perceived as "an old boys' network" where a small number of people have a large number of NED appointments. The concern is that this may militate against either tough decision making or a proper time commitment to individual directorships.

So far as non-family NEDs of private family companies are concerned it is therefore desirable that appointees:

- In general should not be a close acquaintance of the Chairman or CEO (Sometimes such an appointment could be justified – but on a strictly limited basis)
- Should not have too many active NED appointments
- Should not be appointed at one time for an extended period beyond normal re-election procedures. Additionally, it should be clear how long it would be expected the appointee should serve (with perhaps a ‘failsafe’ available in terms of a notice period of say six months)
- Should not receive excessive remuneration

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

- 4.1 We do not believe that this is an issue in a private family company where by definition other members of the board will usually also be the substantial shareholders in the company. However it will sometimes be the case that substantial sections of the controlling family are not directly represented on the board. In such circumstances the NEDs should encourage the creation of Family Shareholder Councils where the directors as a whole can communicate with major shareholders or their representatives and obtain a clear understanding of their concerns and priorities.

E. How can NEDs best be supported to perform their role?

- 5.1 The effectiveness of NEDs is very much in their own hands both as regards their ability to judge the right degree of information and knowledge they need, in their analytical capability and in the weight of their personalities.
- 5.2 It may well be appropriate for your report to stress the right of NEDs to receive such information as they may require in pursuance of their duties. The knowing provision of false or incomplete information to a NED might also be recognised as a Company Law offence. However issues such as this will be far more important in a listed company than in a private family company as a result of the short-termist pressures which are often present in the former.
- 5.3 A key issue is the availability of sufficient NED candidates with the requisite experience and ability. It is important in a large private family company that there is not simply one NED independent from the family but two or even three if the size and complexity of the business make this desirable. It is already the case that databases of candidates exist either on the Internet (for example NEDnet.com) or else maintained by major commercial recruitment agencies. In our view the cost effective means of identifying suitable candidates requires to be generally publicised.