



TUC response

Review of the role and effectiveness of non-executive directors

Introduction

The TUC welcomes the review of the role and effectiveness of non-executive directors established by the DTI and the Treasury under the leadership of Derek Higgs. Trade union members are directly affected by the decisions made in boardrooms, and by the corporate governance system that creates the structure and priorities for that decision-making process. The calibre and experience of executive and non-executive directors clearly has a direct influence on how companies are managed and on the working lives of their employees. We welcome this opportunity to offer a trade union perspective to the review.

Over the last ten years, non-executive directors (NEDs) have become an increasingly important part of the corporate governance system in the UK. The recommendations of the Cadbury Report of 1992, the Greenbury Report of 1995 and the Hampel Report of 1998 all emphasised the need for NEDs to play a monitoring function in relation to the executive directors of the board. The Combined Code on Corporate Governance recommends that NEDs should comprise at least one third of the board; that a majority of these should be independent from management; that remuneration committees should consist exclusively of independent NEDs; that audit committees should consist exclusively of NEDs; and that a majority of nomination committee members should be NEDs. Thus responsibility for ensuring high standards of corporate governance falls largely upon the NEDs. Events at Enron and WorldCom illustrate how important corporate governance standards are to company survival and the interests of the stakeholders involved.

Some have argued in the post-Enron debate that 'it couldn't happen here' because our corporate governance systems would prevent such abuses. There are certainly important differences between UK accounting systems and those of the US which would make an

Enron-type deception harder to accomplish in the UK. But the UK system has its own weaknesses, and the TUC is concerned that, as presently constituted, NEDs are a weak link in the UK system of corporate governance.

If NEDs are to perform their monitoring function effectively, it is absolutely essential that they are independent of management and able to voice independent views. However, at present the vast majority of NEDs are executive directors of other companies, with similar backgrounds and interests. Many are known to members of the board before they are invited to become a NED. Why did the NEDs at Marconi not stop George Simpson throwing all the companies' eggs into the risky telecommunications basket? Why were the NEDs at Railtrack and Wickes not able to challenge poor decision-making and performance by the board? NEDs as presently constituted and appointed are not able to act effectively in the monitoring capacity needed to safeguard corporate governance standards and quality decision making. These points are elaborated below.

A What role should non-executive directors perform, and how does this compare to the present position?

A1 The Role of the Board

The role of the board is to run the company effectively and ethically, managing business strategy and positive stakeholder relationships for the success of the enterprise. The board makes key decisions in terms of company strategy and operations, and bears ultimate responsibility for the actions and relationships of the company. It is responsible for ensuring high standards in corporate governance and company practice.

A key role of the board, which runs through all of its business strategy, is to manage its relationships with its stakeholders effectively. For employees, and indeed for other stakeholders, this means building up long-term, committed relationships based on respect and trust. Ensuring that the company has an effective strategy for employment relationships and monitoring that strategy is a key boardroom responsibility. The executive director or senior manager with responsibility for employment relationships should sit on the company board, and at least one of the NEDs should have employment-related experience. This is returned to below.

In countries that have two-tier board systems such as the Netherlands and Germany, there is a formal split between the executive functions of the main board and the monitoring function of the supervisory board. This separation makes the role of each and how they relate to each other very clear. In the UK, the monitoring function is carried out within the main board, and the separation is between executive directors and NEDs. But because the NEDs do not operate in a separate sphere from the executive directors, there is a sense in which the board is monitoring itself. This raises serious questions about the clarity and workability of the monitoring function in UK.

Professor John Kay and Aubrey Silberston have argued that the absence of effective monitoring of executive directors makes companies more like the one party states of Eastern Europe: 'For all but the most remarkable of men and women, authoritarian structures are insidiously corrupting. Leaders hang onto power too long, and many prefer to undermine those who might seek to replace them rather than to develop potential successors. Cults of personality develop, and are supported by sycophantic lieutenants. These are often associated with inappropriate accretion of privileges, and excessive fascination with the trappings of office? These features are as common today in business as they were once in politics' (*National Institute Economic Review*, August 1995). This is an environment in which there is a vital need for effective and independent monitoring.

A2 What should be the key roles of NEDs?

Non-executive directors should have two key roles:

- They should bring to a company experience and ideas that may not be available internally; this may be experience of different sectors, operations overseas, experience of stakeholder relationships or of different ways of managing and involving staff.
- They should provide an external check on company management, ensuring that boardroom decisions are in line with best practice in terms of both corporate governance and company management. A key area that they should monitor is employment relationships.

The TUC believes that it may be impractical for all NEDs to perform both these roles. What is essential is that the board has a proper balance between the two.

The monitoring role of NEDs covers the whole spectrum of company decision making and practice. They need to be sure that executive directors and other company managers are carrying out their roles responsibly, and that the company is being managed effectively. In addition to their specific roles on remuneration, nomination and audit committees, they need to be apprised of relationships with employees and suppliers, marketing and sales practice, media strategy (especially for large companies) and so on.

A3 How does this compare to the present position?

At present, is it clear that NEDs are not doing enough to guide, challenge and curb company management. The gap between best practice and the reality in many of Britain's companies in a whole range of areas, including corporate governance and employment relationships, is illustrated by the examples of Marconi, Railtrack and Wickes referred to above.

A4 How independent do non-executive directors need to be?

For NEDs to perform a monitoring function effectively they need to be entirely independent. They must not be dependent on the company, or on their position on the board or on other company directors, for anything other than their remuneration. It is important that NED fees do not act as a disincentive to NEDs to bring to light company misconduct.

A6 Time commitment for NED role and implications for number of NED posts held

To understand and be able to comment on the affairs of a company, especially a large or complex company or one that is undergoing a process of change or expansion, requires a considerable investment of time. Any one individual will only be able to contribute effectively in a limited number of NED positions. This is particularly true if the NED is also an executive director of another company.

A7 Special role for a 'senior independent' NED?

A special role for a senior, independent NED could be useful in providing a focus for other independent NEDs and for shareholders and stakeholders who have concerns about the decisions of the board.

A8 Directors' duties

The TUC supports the revised wording of directors' duties as set out by the company law review, and in particular their clarity on the need for directors to build positive relationships with employees and other stakeholders.

Putting this point to one side, given the specific responsibilities and roles ascribed to them in the Combined Code, the TUC believes that there is a strong case for separate duties for NEDs. NEDs are at the heart of the monitoring system for UK corporate governance, and this should be reflected in their duties. Separate duties for NEDs would help to clarify their monitoring role, which should, over time, strengthen this function with the boardroom.

B Attracting and appointing non-executives

B9 Key skills, knowledge and experience needed over next 10 years

For them to participate effectively in the key decisions taken by boards, a high level of financial knowledge is required of all NEDs. Some of this could be provided through training. They will need knowledge of the sector and markets in which the business operates, some of which could be learnt on the board. An understanding of the different interests and relationships involved in managing an organisation is required.

Also key will be the ability to weigh different priorities, balance different interests and understand the implications of different actions. This is the key skill necessary for effective decision-making, which is clearly a central role of the board.

Experience of complex decision-making can be gained from a huge variety of situations. There are many public sector workers who have to make extremely difficult decisions every day, and are used to balancing competing priorities and managing the ensuing processes of change. There are many people with excellent analytical skills in all walks of

life, including the voluntary sector. Many of these would be able to make extremely valuable contributions to company boards.

It would be hugely beneficial to UK business if boardrooms included people whose experience was drawn largely from a relatively unrelated area. It would bring a fresh perspective into boardrooms, enhance the independence of NEDs and their capacity to monitor executive directors, and help companies understand how their actions will be perceived externally. Most important of all, it would give balance to their decisions.

It would also do much to repair the damaged reputation of British business. Companies are perceived as being run by 'fat cats' who are out of touch with public concerns and values. If there were people from a wider range of backgrounds and occupations on company board, it would give a powerful boost to corporate legitimacy.

B10 Personal qualities and attributes

NEDs need to be able to speak their minds freely, without fear of the consequences. They need to be confident and assertive, able to disagree with a majority view, and be capable of independent thought. Integrity is an essential quality for NEDs.

B11, 12 13 Mix of experience on boards, recruitment and widening the pool of potential NEDs

The benefits of bringing a fresh perspective to boardrooms are set out above.

The TUC believes that it is *highly desirable* if the experience embodied by NEDs includes:

- Someone with experience in a largely unrelated field, with the ability to bring a fresh perspective to the decisions taken.

How staff are managed, involved and motivated can make the difference between success and failure for any company in any sector. Whatever the task or role that staff perform, it is they who are creating the value that the company strives for. Employment relationships have a direct impact on productivity and profitability, and how these relationships are managed is key to successful change management. Boardrooms need both the internal knowledge provided by the director or manager with responsibility for employment

relationships, and an external perspective that is capable of challenging and adding to that internal perspective. In the absence of direct employee representation on boards, this latter role needs to be fulfilled by an NED.

The TUC believes that it is *essential* for the experience embodied by NEDs to include:

- Someone whose experience of employment relationships will enable them to understand the consequences of boardroom decisions from the perspective of the company's employees, and provide insights into the implications of employment relationships for company strategy.

In addition, all NEDs need to have regard to employment relationships.

Establishing a wider pool of potential NEDs

At present, NEDs are drawn from a very narrow pool, consisting almost entirely of executive directors of other companies, with similar backgrounds and interests. Many are chief executive officers (CEOs). TUC research has found that in the FTSE top 50 companies, 11 NEDs held 39 NED positions between them. There were 300 NED positions in total, which were held by just 260 people. The average age of the NEDs was 59 years, and women held just 30 of the 300 NED jobs (*You Scratch My Back*, TUC, 1998).

In over half the NED appointments of 1998, the company already had an individual in mind who was then approached¹. The 'invitation only' manner in which the majority of NEDs are appointed militates against independence and creates the last closed shop in British industry.

It is vital that a wider perspective is brought to the nomination process. Since most NEDs are executive directors of other companies, the current system does not facilitate this, and does not have sufficient capacity to promote change. In the Netherlands, employees have a role in the selection of the supervisory board, and this principle could usefully be

¹ *Chairmen and non-executive directors – Fees, facts and attitudes 1998*, Egon Zehnder International and The Institute for Chartered Accountants, 1998

adapted to the UK system. Employees have a strong interest in the success of their company; they are also closer to the 'outside world' than company directors; and their input would enable the board to be more confident that they had among their members someone 'whose experience of employment relationships will enable them to understand the consequences of boardroom decisions from the perspective of the company's employees, and provide insights into the implications of employment relationships for company strategy' (as set out above). In addition, trade unions have invaluable experience of equal opportunities procedures and best practice in recruitment practices that would be hugely beneficial to nomination committees.

The TUC believes that:

- Employees should be represented on nomination committees through their trade unions. Where no trade unions exist, appropriate arrangements will need to be made for employees to elect a representative.
- The majority of the members of the nomination committee should be independent.
- The nomination committee should be chaired by an independent NED.
- A job description and person specification for NEDs should be drawn up. The person specification should indicate the range of experience that the board requires (not necessarily requiring all NEDs to have all areas of experience).

The current recruitment and appointment procedures have not led to diversity in terms of gender or ethnicity on company boards: the vast majority of NEDs are white and male. This is related to the pool from which NEDs are currently selected: since the vast majority of executive directors are white and male, if they form the main pool from which NEDs are selected, their lack of diversity will be reproduced among NEDs.

In contrast, there are areas of the public sector where women and ethnic minorities are much better represented in senior management. For example, local government has a higher proportion of women managers and directors than the private sector. While the TUC believes that all companies should urgently adopt effective equal opportunity strategies to create more diversity among their top management, appointing NEDs from a

wider range of backgrounds would immediately create a more diverse pool from which to select.

Creating a wider pool of NEDs will require a major commitment to change from companies, business organisations and Government. It will also require some practical steps to help companies put the changes into practice. Outlined below are some suggestions as to how this could be done. What is essential, however, is that if the Government is serious about wanting to see NEDs drawn from a wider range of constituencies, it should take some responsibility for creating the conditions to facilitate change.

- To assist companies in recruiting NEDs from new constituencies, a pool of *potential* NEDs, drawn from a range of backgrounds, should be established.
- The Government should invite organisations with a relevant interest, such as the TUC, the CBI, the NAPF, the ABI, the Accounting Standards Board, the Stock Exchange and so on, to participate in discussions about the practical steps necessary to achieve this.
- The pool would need to be run by a suitable organisation, and public funding should be made available. This would be appropriate, given that the public interest would be better served by more effective and independent NEDs.
- A preliminary recruitment procedure for potential NEDs should be undertaken, with a general job description and person specification that could be used to benchmark candidates, established.
- Advertisements for applicants should be placed in media with the capacity to reach out to a wide range of constituencies.
- Nominations from organisations whose members are likely to have experience that would be valuable to boards, including trade unions, should be sought.
- A training programme that could provide some of the knowledge that would currently be gained on other boards should be put in place.

Companies wishing to recruit a NED with a particular area of experience, such as employment relationships, or companies who simply wished to add breadth to their current boardroom could use this pool as one route through which to advertise.

However, even with these practical steps, without external pressure companies are unlikely to address the lack of diversity in their boardrooms. The Government has a crucial role here, and will need to make a powerful case for appointing NEDs from a wider range of backgrounds to companies. Publicity to increase public awareness of the pool and how to become a candidate for it will also be necessary. The Government should take steps to end the current closed shop among NEDs.

- The Government should carry out a publicity campaign, aimed at companies, putting the case for appointing NEDs from a wider constituency. It should also carry out publicity to raise public awareness of the pool and how it operates.
- Boards should be required to report on how they collectively hold the skills and experience required to carry out their responsibilities in annual reports.

B14 NED pay

The level of rewards for NEDs is not a brake on recruitment of suitable NEDs. Indeed, there are many people for whom the current rewards would be a substantial proportion of their income who would have a valuable contribution to make to company boards. In addition, it is important that pay does not act as a disincentive to challenge company management.

B15 Risks and insurance provision for NEDs

Compared to the risks faced by fire fighters or construction workers, the risks facing NEDs are minimal and far more under their own control. When company boards make bad decisions, it is invariably the company's employees who bear the brunt of the consequences. The emphasis in the Enron debate on the risks of being an NED is inappropriate, given the extent of the losses borne by Enron employees.

C Structures and accountability

C19 Remuneration committees

The Combined Code recommends that boards should set up remuneration committees of independent NEDs. However, because NEDs are nearly all executive directors from other companies, this creates a situation where the same pool of executive directors sitting as non-executive directors on other companies' boards are setting each other's pay. Reports of remuneration committees and remuneration consultants make it clear that a major consideration for setting directors' pay is rates of pay in other companies. This creates a conflict of interest for NEDs who are executive directors of other companies, because they have a direct interest in boosting overall levels of executive remuneration.

Research² has found that 46 of the top FT 100 companies share at least one member of their remuneration committee. Two directors sat on the remuneration committee of four different companies. In all, just 392 directors made up the remuneration committees of 98 of the largest UK companies.

The TUC believes that

- Employees should be represented on remuneration committees through their trade unions.
- Remuneration committees should include only NEDs who are not executive directors of other companies.

C20 Board and NED performance

The TUC believes that boards should be required to report in annual reports on how the board has functioned over the year, drawing out strengths and weaknesses. This would compliment the requirement to report on how the board collectively holds the skills and experience required to carry out its responsibilities outlined above.

² Labour Research, July 1999

D Relationships with shareholders and others

D23 Relationships between NEDs and stakeholders

NEDs should build up independent, open relationships with company stakeholders, including employees. They will need to hold meetings with stakeholders and their representatives, and ensure that they have sufficient knowledge and understanding of their perspective to enable them to make effective decisions taking their interests into account.

E Support

E29 Training and induction for NEDs

Induction programmes for NEDs should include meetings with employees and their representatives. Training programmes for NEDs (and other directors) should include information on employment relationships. The TUC would be happy to work with relevant organisations to produce suitable training materials.

G International context

The split between the executive and monitoring functions of the main and supervisory boards in countries such as the Netherlands and Germany has already been referred to above. In Germany, there is worker representation on the supervisory board, whereas in the Netherlands employees have a role in the selection of the second board. There are some lessons that we can learn in the UK from such systems. Firstly, the monitoring function is dealt with much more clearly in this structure than it is currently in the UK. This could be addressed in the UK to some extent by developing separate duties for NEDs that spelt out their monitoring role. In addition, supervisory boards, either because of their composition or the way in which they are appointed, are often better at giving employees and other stakeholders a voice in the boardroom. This could be addressed in the UK through: a requirement for NEDs to include someone with experience of employment relationships; NEDs building up open and transparent relationships with stakeholders; and the inclusion of employees on nomination committees.