

Review of the role and effectiveness of non-executive directors

Response to consultation exercise

Stephen Cooke and Mark Bishop,

Voices of Experience Limited

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Introduction

Voices of Experience Limited is a search and selection (also known as 'headhunting') firm, based in Pall Mall, London. The business was founded in August 2000 and specialises in recruiting non-executive directors to the boards of UK companies.

In the first phase of the company's development it focused on assisting with the appointment of independent directors to the boards of the investee businesses of private equity firms. The company has recently launched a quoted company practice, as part of the development of which it recently undertook a survey of attitudes and behaviour among 250 non-executive directors of companies listed on the London Stock Exchange (including AIM and OFEX).

Most responses were returned anonymously by post or email, though close to 30 non-executives volunteered to meet with us to give fuller explanations for their answers. A full set of the results is appended.

Voices of Experience Limited has also consulted with major fund managers and their representative bodies, via confidential one-on-one interviews. The observations and recommendations made in this submission represent a distillation of both pieces of research and the views of the company's directors, who are committed to the principle that companies well governed in the long-term interests of all stakeholders are the engine-room of the UK economy.

Our submission is presented in the format of answers to questions posed in Derek Higgs' consultation paper dated 7 June 2002. For brevity, we have not repeated the questions; this submission should thus be read in conjunction with the aforementioned DTI document.

A: Role

1.

The role of the board is (or should be) to set, review and evolve the strategy and lead and review the operations of a company, where necessary taking anticipatory or remedial actions, in order to maximise the commercial success of the business and thus deliver sustained economic benefits to its stakeholders, the most important group of which is its shareholders.

The role of the Chairman is to chair meetings of the board, and typically also those of the shareholders. By extension, the Chairman is often (though not always) a public figurehead for the company, sets the agenda and tone of debate at board meetings and acts as mentor, critic and 'dotted line' manager to the Chief Executive Officer.

The relationship between the role of the Chairman and that of the non-executive directors is complicated by the diversity of post-holders currently described as Chairmen. Some are executive; others non-executive; of the latter, some are former executive directors (typically Chief Executive Officers) of their respective companies, while others have backgrounds with other companies or in other sectors.

The one common factor in the relationship between the role of the Chairman and that of the non-executives is that the latter are members of a board of directors chaired by the former. In many (though not all) cases, the Chairman is, by default, responsible for the health and balance of the board, including the effectiveness (and often appointment) of the non-executive directors.

2.

We would suggest that the principal role of non-executive directors should be to act as the defenders and advocates of the best long-term economic interests of the company's stakeholder groups other than the executive directors.

Non-executives is that they should aim to minimise the exploitation of the potential that exists in the model of a shareholder-owned, executive-managed business the potential for the latter to manage the business in their short-term benefit but to the detriment of the interests of the former – and, indeed, those of other stakeholders such as employees, lenders, customers, suppliers and the local community.

It is important to clarify that this disconnect need not imply dishonesty on the part of the executive management team; on the most innocent level, Chief Executive Officer may believe that he or she is doing the utmost to deliver sustained value for a company's stakeholders but is failing to do so through lack of ability or a mismatch between individual skills and experiences and those required by the circumstances.

If one accepts the foregoing, it follows that there are a number of component elements to the role of a non-executive director. While our survey indicates the relative amounts of time devoted to these by current non-executives, we do not feel that it would be appropriate to establish a hierarchy of importance to the duties, which we believe include:

- (i) Ensuring, to the best of one's ability, that the company is pursuing the optimum strategy for the given circumstances. While non-executives should not be expected to take the lead in this area, they should give freely of their knowledge and experience and not confine themselves to testing and examining strategies developed by the executive directors, whether in advance of implementation or in retrospect;

- (ii) Monitoring and reviewing the quality and outcomes of the operational execution of corporate strategy;
- (iii) Taking all reasonable steps to ensure that all financial statements and market-sensitive information released by the company is both accurate and necessary;
- (iv) Acting in the best interests of stakeholders in determining the appropriate level of remuneration for executive directors, having in mind both the relationship between reward and the amount of shareholder value created (or destroyed) and the potential to damage the business should it lose, or fail to attract, the executive talent needed to maximise economic returns to stakeholders;
- (v) Deploying such tactics as are necessary to reform or, if unsuccessful, remove any executive directors who damage, or appear likely to damage, stakeholders' interests, whether through impropriety or lack of capability or application and ensuring that any board-level executive vacancies are filled by the most capable and honest candidates available to the company

We believe that all non-executives should contribute to all of the above duties, with the possible exception of the audit-related responsibilities outlined in point (iii). Although only 22% of respondents to our survey felt that members of an audit committee should possess appropriate financial qualifications, we feel that the level of expertise required meaningfully to interrogate a finance director or auditor and be able to recognise whether the responses represent a full picture of the truth under current accountancy guidelines is unlikely to be widely found among laypeople.

3.

The present position regarding the roles of non-executive directors is depicted in some detail in the appended survey (section 3.1). Our only observations would be that we are disappointed that current non-executives appear to spend little time making their own enquiries outside formal board meetings – for instance, talking to divisional managers and finance staff in pursuit of audit queries (3.1.k), making enquiries into directors' remuneration at other companies rather than relying on consultants' recommendations (3.1.m) and interviewing and referencing candidates for board vacancies (3.1.p-q).

4.

Our view on this is uncompromising: we believe that non-executives who are not independent of every major stakeholder group (especially the executive management team) or their consultants or advisors, are unlikely to be able effectively to perform the role – and even if they were able to do the job, they would be unlikely to enjoy the full confidence of other stakeholder groups.

Furthermore, we believe that the definition of independence needs to be reviewed and updated. We support, as a minimum, the guidelines issued this year by the National Association of Pension Funds (NAPF). Once a common standard can be agreed upon we believe that measures should be taken in order to ensure that they become widely adopted by quoted companies in the UK as we believe even the minimal requirements of the Combined Code are only very loosely observed by a substantial minority of companies.

We agree with the Government, and Derek Higgs, that a voluntary code is preferable than legislation. However we also believe that some form of incentive may be required in order to encourage preferred behaviour. We note that much positive progress has been made by the Government in recent years to encourage best practise in the financial services sector through the promotion of kite mark-style awards for businesses that meet defined criteria for transparency and consumer value (for instance: CAT-standard Individual Savings Accounts and Stakeholder pension plans).

Were the Government to promote a 'good governance award', given to companies that are able to demonstrate that they meet an agreed set of best practise guidelines, fund managers could choose to invest solely in these firms, creating a powerful incentive to others to raise their game.

5.

In our response to question two, we have outlined the broad area in which we believe there may be conflicts of interest within a company, where non-executives can play a role in protecting the interests of stakeholders.

Naturally, there are a great many areas in which this inbuilt tension can manifest itself. Here are a few examples:

- (i) Executive directors want to maximise their remuneration. Executive remuneration, as a cost to the business, is something that shareholders will want to minimise, excepting only that they wish the company to maintain the ability to retain and attract capable executives. Non-executives are expected to form the majority on remuneration committees that determine executive pay; however, only four percent possess any qualifications in the area of pay and incentives, most rely on the recommendations of a single consultant appointed by the executives and 71% believe these recommendations may be unnecessarily generous. Tasking non-executives to make their own enquiries, and appoint their own consultants, might help here;
- (ii) Executive directors benefiting from long-term incentive plans (LTIPs) and other time-defined share-based remuneration may see it as being in their interests to manage peaks and troughs in the company's share price. Long-term shareholders, including particularly institutional investors, would rather the business be managed for sustained, gradual growth. Here again, non-executives have a valuable role to play, not only in determining the rules for LTIPs but also in ensuring that any information released to the market that is potentially price-sensitive is necessary and appropriate in its content and timing;
- (iii) Executive directors, especially the less capable ones, want to remain in post, whereas it is in the interests of other stakeholders that they be swiftly removed. In practise, this tends to be the responsibility of the Chairman, and is made complex by the fact that some Chairmen are executive (or semi-executive) and could perhaps themselves be the people requiring removal and others are former executive directors who may have appointed, or hampered the activities of the Chief Executive Officer. The role of non-executives may need to be redefined to encourage them to meet formally to consider the performance of the executive directors (91% believe this is a good idea, but 81% don't currently do it).

6.

We find it difficult to comment on the time commitment required of Chairmen because of the wide disparity in the roles and status (executive versus non-executive) of those holding this post. The average, according to our survey, is 5.2 days per month, though the spread was enormous (from 1 to 20 days). Non-executive directorships consume an average of 1.9 days per month and displayed a smaller range (0.5 to 6 days).

Because the survey was completed anonymously we are unable to determine whether there exists any correlation between size of business (or type of listing) and time commitment, but the heavier time commitments were linked to higher remuneration and we suspect a correlation between this and company size.

However we have already made a number of observations relating to the responsibilities of non-executive directors that would, if adopted, entail directors spending more time with each company.

In particular, formal meetings of the non-executives without executives present and requirements or expectations to appoint auditors, make one's own investigations into the accuracy of financial inputs, appoint and consider the findings of more than one remuneration consultancy and interview candidates for board-level positions would probably more than double the time commitment for a typical non-executive.

It is self-evident that this would reduce the maximum number of positions that any one individual could sensibly hold and increase the expected level of remuneration. For those who do not hold executive positions, we believe that the following combinations represent sensible upper limits:

- (i) Two non-executive chairmanships;
- (ii) Five non-executive directorships
- (iii) One non-executive chairmanship and four directorships

We believe that non-executive positions in private companies should be disregarded because the governance aspect of such roles is relatively small and private companies benefit disproportionately from the strategic input of a good non-executive.

We are wary about the wisdom of full-time executive directors of quoted companies also holding non-executive positions; the potential for conflicts of both time and interest is considerable. However, were such arrangements to continue to be accepted by the shareholder community, we believe that a limit should be set of one non-executive directorship (not chairmanship).

It is interesting to note that our survey indicates that the average non-executive director already holds 5.2 positions – more than the upper limit currently recommended by the National Association of Pension Funds – and that 81% are looking to increase the number of posts that they hold.

7.

We understand the role of a senior independent non-executive director to be that of acting as the main point of contact for institutional shareholders who wish to express a view about the running of a company that they feel they cannot put to the Chief Executive Officer or Executive Chairman. In cases where there is a fully independent non-executive Chairman, there is seldom a separate senior independent non-executive director.

In principle, we prefer the latter model because we believe that an executive Chairman may represent too much power in one pair of hands and a Chairman who lacks independence (especially one who is the former CEO of the company in question) represents a potential brake on the freedom to act of his successor. However, we believe that the extent of entrenched interests is such that it will be difficult, in the short to medium term, to establish and enforce the principle that a fully independent non-executive Chairman is the only accepted model, and thus we believe that the appointment of a senior independent non-executive is a suitable palliative measure.

A broader question would be "what should be the role of the independent non-executive Chairman, or senior independent non-executive director, particularly in relation to shareholders?" We will cover this point in section D of this submission.

8.

While we do not disagree with the principle that the legal duties of executive and non-executive directors should be identical under company law, are concerned about the possible consequences of this axiom, namely that both classes of director should be deemed equally culpable should the company be judged to have broken the law and, worse, that all directors should be jointly and severally liable for consequential losses.

The latter point can be particularly hazardous for non-executive directors, whose seniority and prior business experience means that they often have greater liquid assets than their

executive counterparts, making them the prime targets of speculative litigation – even though their rewards for membership of a given board are negligible relative to the assets that they could be putting at risk. Smaller wonder that the US has already seen a number of high profile former CEOs publicly state that fear of litigation means they will not accept non-executive posts.

Our recent survey showed an overwhelming 97% support for the principle that non-executives should not be held criminally or financially liable for the misdeeds of a company. As one non-executive said to us during the course of the survey:

“My CEO sails a bit close to the wind. I see myself as the conscience of the business, doing what I can to stop certain people from doing things that would damage the company’s good name. On a couple of occasions the CEO has been cooking up something dodgy and I’ve had a quiet word with him to stop. This has always done the job, probably because he knows I’d resign and go public if it continued. But if the consequence of bringing something like this into the open was that I’d be dragged through the courts and could lose everything, I’d be tempted to cover it up and let it continue. The bluff would no longer work.”

It may be more useful to relate the potential criminal and financial liabilities of directors – executive and non-executive – to their duties, as outlined in their job descriptions. If a non-executive director has been hired to ensure that, for instance, the annual accounts and other financial statements issued by the company are accurate, then assuming that person has been given all reasonable resources to perform the function (including the right to appoint auditors and roam freely about the business, making his or her own enquiries) then it may be reasonable to suggest that the individual in question may be liable should the company’s accounts subsequently be determined to have been misleading.

By contrast, another non-exec serving on the same board might not have Audit Committee responsibilities but might instead have been hired for strategic input or assistance with remuneration matters; to expect him or her to be liable would clearly be unreasonable.

As a side issue to the above paragraph: we wonder how many non-executive directors possess clear, up-to-date, written job descriptions. We believe this is an essential requirement, yet suspect it may be absent in most instances.

At the heart of the operation of a unitary board is the principle that, much like Cabinet, whatever debates or disagreements take place behind closed doors, and however narrow the margin by which any decision is approved, once a decision is made it becomes the policy of the company and should be given public support by all directors. This notion of the board as a single, controlling mind, is in our view the justification for the lack of distinction in law between executives and non-executives.

We believe this needs re-examination, not only because it could threaten the availability of capable candidates for non-executive positions but also because it is one of a number of factors which we have identified that we believe push non-executives towards identification with executive directors, making it harder for them to take a constructively critical, independent stance.

While we support the principle of a unitary board, as the formal meeting forum for executive and non-executive directors, we also believe it is beneficial for non-executives to hold separate meetings, and indeed for executive directors, as most do, to continue to hold operational sessions between unitary board meetings. We believe it would be beneficial clearly to define the purposes and scopes of each type of board meeting and for directors to be held to account only for those areas for which they were clearly responsible.

We also feel that there could be a role here for company secretaries, in encouraging Chairmen to take more decisions to votes and recording not just the numbers but also the identities of those dissenting from the majority view; they would then be in possession of a strong defence should the matter be subject to subsequent litigation.

B: Attracting and appointing non-executives

9.

We believe there are two key areas in which non-executive directors of quoted companies require knowledge and experience:

- (i) They should have an understanding, preferably first-hand, of what is involved in being a main board director of a quoted company of broadly comparable size and in similar structural circumstances to the one on whose board they wish to serve as a non-executive. This is likely to include an appreciation of corporate governance issues, shareholder and other stakeholder concerns and motivations and legal and regulatory constraints. They should also be financially literate, especially if serving on the audit committee, where we believe that financial qualifications are a major advantage, and ideally have some awareness of senior executives' remuneration levels;
- (ii) They should also have sufficient understanding of the sector and markets in which the company in question operates to be able to make a positive contribution to the development of corporate strategy. We do believe in a degree of diversity within a board; so for instance an engineering company should include some directors from outside of that sector. It should be borne in mind that such individuals may require an extended induction process in order properly to understand the company, its markets and its competitors. When recruiting outside the sector, nomination committees should look for flexible candidates who have previously demonstrated success in moving to new sectors.

We do not believe that these core requirements will change with time. However we do accept the principle that a board functions best when there is a certain diversity of backgrounds and experiences within it and thus a variety of perspectives and insights can be brought to bear on a given debate.

If, for instance, the enquiry felt that those non-executives who sit on, for instance, the audit committee should all hold accountancy qualifications, it follows that there should be sufficient non-executives on the board for their tally also to include people who possess quite different academic qualifications and progressed via other career paths.

10.

On the question of the personal qualities and attributes needed to make a good non-executive, we echo the words of one non-executive chairman, in our view one of the most effective and principled we've ever encountered, who preferred to meet with us to convey his views for our survey:

"The first thing I look for is a thirst for information and an obvious ability to digest it quickly but pick out and use only the really important bits. The kind of person who probably has a lot of interests in their business and personal lives. The next has to do with how they get on with others. Someone who can converse happily with people at all levels and wins their trust. The final point, and in a way the most important, is their motivation. I'm not interested in people who go to work to get paid; they have to believe in a set of principles and a greater good or purpose to business. Again, looking at a CV, I would be interested in someone who was involved in a place of worship, a political party, a pressure group or a charity."

To this we would add just one point: in our experience a non-executive director should also possess sufficient financial independence to be able, when necessary, to jeopardise their fees from a given non-executive position. We are aware of a number of instances where serving non-executives have taken positions that have resulted in them being unpopular with executive directors to the detriment of their term of service on a board, and of others where non-executives have resigned on points of principle. We were surprised that our survey revealed that 48% of the non-executives that we surveyed claimed to have taken the latter step.

11.

We have covered the mix of experience and attributes above. Regarding specific examples of contributions made to company performance or governance by well-recruited non-executives, we can provide one of each:

- (i) We were recently asked to find a deputy chairman for a small quoted company, the strategy of which is to expand into Eastern Europe. Client confidentiality precludes us from identifying the company. We were able to find a candidate who not only possessed the requisite City experience to contribute to the company's governance but, fortuitously, an individual with some sector experience who was bilingual in Polish, spoke fluent Russian and had extensive experience doing business for a UK company in Russia and the Ukraine. Our client took the view that while it was the executive directors' role to identify and evaluate acquisition targets in those territories, their new Deputy Chairman would be invaluable in helping them to understand business mores in that region, while his language skills would make him an excellent choice to front initial discussions;
- (ii) The troubled Marconi plc recently appointed Allen Thomas as a non-executive director. While this move attracted less press attention than the earlier appointment of Derek Bonham as interim Chairman, we believe it was in many ways a more significant move. Thomas's background included a number of debt-for-equity swaps, on both sides of the Atlantic. Over the past few months Marconi's board had to grapple with complex and conflicting advice while at the same time maintaining lenders' confidence and protecting at least some value for shareholders. We believe that Thomas's presence on the board is likely to have been a major factor in the negotiation of a survival package for the company

12.

As a search firm specialising in independent directors we might be expected to have a vested interest in saying "it's very difficult". However, this would be untrue. A look at our survey explains why: although 78% of non-executive chairmen and 71% of non-executive directors regard their remuneration as "a little low" or "frankly insufficient", 81% of them are currently looking to take on additional positions. Our reading of the situation is thus: the money isn't great, but they're doing the work for reasons that are primarily not financial.

With plenty of candidates available – and remember, we were surveying only those already holding non-executive positions on the boards of quoted companies in the UK, and there are plenty of candidates who would like to take on their first non-executive directorship if given the chance – finding candidates with the appropriate knowledge, experience and personal attributes is not hard.

Every day, we receive an average of six unsolicited contacts from people who wish to be considered for their first, or an additional, non-executive position. Perhaps a quarter of these are frankly unsuited to such posts; a similar proportion have excellent CVs weighted towards entrepreneurial roles in private companies, making them best qualified for non-executive roles with management buyouts and other businesses backed by private equity. This leaves perhaps 1000 people a year contacting us who are ideally suited to independent director posts on quoted company boards – and that's before we begin to exercise our professional skills and go out to find candidates with specific backgrounds for particular vacancies.

Our biggest problem is not finding superb candidates but being instructed by companies to help them fill non-executive vacancies. There are two reasons for this:

- (i) A great many positions are filled by variants on "the old boy network". In most cases, there is no intent on the part of the executive directors to appoint a tame or uncritical non-executive; they may simply become aware that a friend or acquaintance whose strategic thinking and City reputation they admire is available for non-executive work, or may have an excellent candidate brought to their attention by their bankers, auditors or other professional contacts;

- (ii) Where a search consultancy is retained to assist in filling a vacancy, it is generally one of a handful of general-purpose board-level practices based in the West End. These firms have high cost bases and are used to handling assignments for full-time executive positions, for which the fees are significantly higher than in the cases with non-exec posts. We are aware of a number of consultants in such firms whose standard course of action is to present a shortlist consisting either of the same few serial non-executives that he or she has placed elsewhere previously or of candidates who were considered for previous executive positions with the same client but never reached the shortlist. In other words, the time is not taken to carry out primary research in order to identify fresh and appropriate candidates.

We believe that a lot could be done to improve the recruitment and appointment mechanisms, including Nomination Committees. While we are aware of some shining examples of good practice, particularly among larger firms' boards, in many smaller quoted companies we believe that the Nomination Committee meets infrequently if at all and its role in determining the composition of the board – particularly in respect of non-executives – is marginal. We propose that serious consideration be given to the process – both within and outside the company – of how non-executives are short listed and appointed, because we believe that well defined and readily actionable improvements in these areas will result in a significant improvement in the quality and quantity of candidates from among whom appointments may be made. We shall cover these points in more detail in our response to question 13 (below).

13.

In our view, the biggest factor militating against a widening of the pool from which non-executive directors are drawn is the method by which candidates are short listed for vacancies – see points 12(i) and 12(ii), above.

Executive directors and company chairmen recruiting acquaintances, or candidates recommended by acquaintances, is a sure-fire way of perpetuating a clique of individuals who are similar to, and probably know, one another. While one should not be quick to condemn the positive aspects of this – there is something to be said for readily-referenced individuals with proven business expertise – the obvious risks are that the perspectives brought to bear on strategic discussion are less diverse than might otherwise be the case and, perhaps more dangerously, that the existence of peer-group relationships between executive and non-executive directors may have the effect of tempering the independence of the latter.

The fielding of 'serial non-executives' for numerous vacancies by the same search consultant is also a contributor to poor governance, primarily because it perpetuates the situation in which a small pool of relatively homogenous candidates fill a great many positions.

In the past 12 months we have spoken to a number of supremely qualified individuals who, on the evidence of their career achievements, ought to have found it easy to acquire non-executive posts with quoted companies but who have failed to do so because they are not sufficiently 'networked'. Specifically, the feeling is that individuals may help themselves acquire non-executive positions if they have given plenty of work to figures within certain general practice board-level executive search firms.

Two interpretations can be put on this observation: while the less honourable version – that cushy non-exec placements can be the pay-off for down-shifting CEOs who have been good clients in the past – the more innocent version, namely that current non-execs are more visible to a time-pressured search consultant than able candidates currently outside the loop, may well be closer to the truth in many cases.

If there exists a genuine intent to widen the pool of suitably qualified candidates who are recruited to non-executive positions, we believe that consideration should be given to promoting the following procedures:

- (i) Other than in exceptional circumstances, non-executive positions with quoted companies should be advertised in the national press in order that all interested parties can apply (in our survey, this was supported by 92% of respondents);
- (ii) A shortlist from among the applicants should then be drawn up by independent search consultants, working to a job and candidate specification that has been

drawn up in consultation with the full Nomination Committee (survey response: 88% support);

- (iii) Candidates for non-executive positions should undergo formal interviews by the full nomination committee and be subject to background checks by independent consultants prior to appointment (86%)

We find it depressing that only 3% of current non-executive directors applied for their most recent appointment as a result of seeing it advertised in the press and that only 11% participated in one or more formal selection procedure/s with the full Nomination Committee (NB: where responses were not received anonymously, we were able to determine that fully functioning Nomination Committees are seldom found outside the FTSE-100).

Prior to surveying non-executive directors, the directors of Voices of Experience Limited consulted informally with fund managers and their two representative bodies to understand their views. We were interested to note that while one professional association felt that few fund managers wanted any opportunity to influence the appointment of the non-executives whose primary role is to act as advocates of their clients' long-term interests, this was not the view of many fund managers.

A minority of institutional investors feel that fund managers who speak for a significant shareholding – say 3% – in a quoted company should have the right to be consulted about the identify of the search firm, the job and candidate specification and the search techniques used in the short listing process and in some cases also wanted the right to interview short listed candidates and express their preferences about the appointment.

Many more fund managers – probably the majority – felt, primarily due to pressures of time, that they did not want to be this close to the appointment process. However, they did wish that the search firm handling a given vacancy could usefully consult informally with major shareholders about the preferred candidates for a non-executive position and give them the opportunity to provide informal feedback on their views on the suitability of that appointee.

It has to be said that our subsequent survey of non-executive directors showed almost unanimous opposition to most proposals under which institutional investors would have any involvement whatsoever in the appointment of non-executives (survey questions 1.7 d; f-j).

A cynic might say: “one cannot expect turkeys to vote for Christmas”. While we do not dismiss this view, we would stress that it was not confined to the types of non-executive who, for instance, amass numbers of posts that many would consider unacceptable. It was expressed with conviction by a number of high-profile non-executive directors and chairmen whom we know to be principled and highly effective individuals.

Our view is that consulting major shareholders at the outset of the recruitment process (about the job and candidate specifications, and the search techniques to be applied) and at the end (do they have any specific objections to the Nomination Committee's preferred candidate) is a reasonable courtesy and prevents any subsequent damage to the company's share price caused by an activist shareholder calling for a controversial non-executive to stand down.

However, we also accept that this move is too radical to enjoy widespread support in the current climate so, while we will happily apply these procedures for any client that requests it, we equally accept that we're unlikely to be asked to do so in the near future and that the current consultation exercise is unlikely to recommend that this become standard procedure.

As an aside, as well as asking what can be done to “widen the pool of non-executive directors”, this question asks us also to consider issues of “diversity”. If these two terms are deemed to be synonymous, we believe we have addressed the point. However, if diversity means “increasing the proportion of appointees who come from specific groups that are currently under-represented [i.e. women, ethnic minorities and the disabled]” our view is that the obvious constraint on this objective is that, in order that non-executives can properly perform the strategic and governance aspects of the role, they do need to have behind them a significant track history as business leaders.

The implication of this is that the diversity of non-executives will not merely mirror the degree of under-representation of these groups in board-level executive positions but lag behind it because it will reflect, in broad terms, the ethnic and gender mix prevailing in such positions a decade or so ago.

In any other sphere of business, one would probably conclude that the moral and economic imperative to extend opportunity to all people of ability and commitment is such that positive steps should be considered to encourage more candidates from under-represented groups to be appointed to positions. However in the case of non-executive roles, there really is no substitute for having had the appropriate business experience and in our view the role could

be further compromised, at a time when the quality of appointees needs actively to be raised, by measures that apply flexibility in the recruitment criteria in order to promote participation by specific groups.

Regarding international participation on UK boards, we agree that there is scope to increase it, but would ask in how many cases such steps are warranted. The pure governance aspects of the non-executive role are best performed by people with an extensive experience of the regulatory environment, audit standards and remuneration norms in the UK. In some cases, for instance where a company is trading extensively overseas (or intends to do so) there may be value in having some strategic input from directors whose experience is primarily in those markets, but in many others the value of UK-oriented understanding may be greater.

In conclusion to our response to this question, we would like to take the opportunity to stress that we believe that the application of an open, transparent, meritocratic and, above all, independently overseen recruitment process in the appointment of independent directors should be one of the key measures of good governance.

Were the Government minded to support our proposal that some kind of 'kite mark' should be introduced to reward and highlight those companies that have met or exceeded whatever is eventually defined as best practice, we believe that a core component of any checklist by which companies are evaluated for such an award is the means by which its non-executives were appointed.

14.

The question of levels or remuneration is covered in extensive detail in section 2 of our survey of non-executive directors and chairmen. In summary, most do consider themselves underpaid, we have asked them to suggest appropriate levels of remuneration and a proportion of them have already, or will in the future, turn down positions because the fees are insufficient.

Were the role to be expanded (for instance by following our recommendations that meetings of the non-executives without non-executives present be formalised; that the audit committee should appoint auditors and spend more time understanding the dynamics of operating divisions; that the nomination committee should meet formally in all quoted companies and that the remuneration committee should commission its own reports and members make their own enquiries) it is clear that the time commitment would increase, the need to apply an upper limit to the number of posts held by each non-executive would become absolute and consequently remuneration would have to rise, probably to at least the levels that our survey has recommended.

The point has been made by others that increasing the remuneration of non-executives could paradoxically reduce their independence by increasing the financial sacrifice were they to step down from a company's board because of concerns about how the business was being run. We disagree with this view because we believe that resignation should be the last, not the first, resort for a non-executive who does not like what he or she sees.

We believe that it is preferable to have well remunerated non-executives who wish to remain with a company, but who also know that their reputations and employability in such roles in future are dependent on ensuring that all companies with which they are associated enjoy a scrupulous track record. That way they will have an incentive to confront any under-performance or lack of integrity in the management team and stay on board to work through any necessary changes, rather than quitting because the rewards do not warrant the conflict and hard work that may, on occasion, be necessary.

We have already expressed concerns about the prevalence of long term incentive plans having fixed vesting dates for executive directors because we believe that these create an incentive to manage a company for peaks and troughs in share price. We therefore oppose the extension of such schemes to non-executives (and are surprised that this proposal was supported by even 6% of non-execs).

While the notion of aligning non-executives' interests with shareholders by paying the former in shares rather than cash found favour with only 16% of our survey, we note that 42% of respondents were 'not sure'. Our view is that such a measure may have merit, especially if combined with measures ensuring that non-executives could not sell such shares until their association with the company in question has ended.

15.

While non-executives are normally covered by blanket D&O (Directors' and Officers' Liability) insurance purchased by companies, there are two reasons for believing that policies covering an individual non-executive for plural roles should be more widely available.

The first is that a company, particularly one listed on either of the junior markets, might by intention or design fail to arrange or renew suitable group insurance – something for which non-executives are not responsible and of which they would have no knowledge.

The second is that D&O policies can be rendered void by any one of a wide range of forms of misconduct by the executive directors. While it could be argued that non-executives are appointed to spot and resolve such problems, it is fair to say that an executive team committed to dishonesty may be able to conceal it from the most proactive non-executives, who might then be liable for legal costs and possible compensation were the misdeed to come to light.

C: Structures and accountability

16.

While we support the principle of the Combined Code, we believe that improvement is now required in two areas:

- (i) Observation. We are aware of a great many quoted companies, particularly some of the smaller ones, which conform only in the loosest sense to the Code as currently constituted. Their Annual Reports typically read: “The board considers all its non-executives to be independent”, even though some of the individuals in question clearly do not meet the current definition of independence. Many others – often the smaller companies, but including many on the senior market – have significantly fewer independent non-executives than the Code recommends, yet claim to adhere to it. Still more claim to have nomination and remuneration committees, the frequency of meeting and role (other than rubber-stamping) of which must surely be subject to question;
- (ii) Extent. We believe that the Combined Code should be built upon to strengthen the definition of independence as it applies to non-executive directors. We believe that the following factors all possess the potential to compromise the independence and proactivity of a non-executive:
 - Being a former executive director of the company, including a forerunner or subsidiary business or joint venture partner;
 - Being a significant shareholder of the company, or a representative of a significant shareholder;
 - Being a current or former professional advisor to the company, or an appointee or recommendation of the same;
 - Possessing personal relationships with one or more executive director that pre-dates the non-executive appointment;
 - Holding excessive number of directorships (c.f. Q.6, above) or having other interests that are excessive or incompatible (e.g. politicians);
 - Being too old (some have suggested a threshold of 70) or of insufficiently robust health;
 - Being a current director of a company with which the business has or could have a significant trading relationship or which could be a potential competitor or target (in either direction) for mergers and acquisitions activity;
 - Having served an excessively long period of time on the board (currently I believe some guidelines suggest 10 years; we believe this is too long. Our survey indicated a measure of support for five years)
 - Being compromised by ‘golden triangle’ conflicts of interest (these are situations where an executive director of company A sits as a non-exec on the Remuneration Committee of company B, an executive director of which in turn sits as a non-exec on the Remuneration Committee of company C, an executive director of which then serves as a non-exec on the Remuneration Committee of company A, creating an incentive to drive up rewards to mutual benefit)

17.

We believe that the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors, with two exceptions that we believe require attention:

- (i) We have previously stated that we believe that a forum should exist for non-executives to meet, independent of board meetings. We propose that this be achieved by means of the creation of an additional board sub-committee called something like “the Review Committee”. This should comprise of all of the non-

executives and no executive directors (except possibly the company secretary). We propose that it should meet as frequently as the main board to review the performance and effectiveness of both the management team as an entity and the executive directors individually. Should any concerns emerge, the chairman of this group – who would normally be the senior independent non-executive (who may in some cases also be the Chairman) – should be responsible for feeding them back to the Chief Executive and pressing for any necessary action;

- (ii) While we support the principles of the three traditional board sub-committees, we have already explained why we believe that measures need to be taken to both extend their remits and, in many cases, encourage their effective operation.

It is very difficult to comment on whether board meeting procedures are working effectively because, much like a marriage, it is difficult to determine from the outside precisely what goes on within the closed walls of a given company's board meetings. We have already commented on the pros and cons of the notion of collective responsibility and would add that as the UK becomes more litigious it is conceivable that directors – in particular non-executives – may become more assertive in bringing controversial matters up in board meetings and calling for votes on key decisions.

Regarding board size, we see some extremes within the UK quoted sector. Some FTSE-100 boards are, we believe, too large to promote effective debate. At the other end of the spectrum, it is not unusual to see a small company on the senior market, let alone AIM or OFEX, that has three executive directors and two non-executives, neither of which meets current let alone future definitions of independence. When, as is often the case in these situations, the CEO, FD and 'non-executive' Chairman are also significant shareholders in the company, of which they may well be founders, it is difficult to see how outside shareholders' interests can be promoted, other than through an expansion of the board by increasing the number of genuinely independent non-executives.

Were our proposal that Audit Committee members to be required to possess appropriate accountancy qualifications, in order to maintain a diversity of academic and career backgrounds within a board's non-executive contingent, it follows that the total number of non-executives serving on a small board might have to be increased.

18.

We have covered many of these points in answers to other questions. In summary, we believe that Audit Committees should consist wholly of non-executives but have the power to invite not only the CEO, FD and auditors but also other executives as necessary to provide answers to any questions that it might have about the accounts. We propose that audit Committees should be responsible for hiring and directing auditors.

While our survey indicated that most non-executives believe that accountancy qualifications should not be a prerequisite for serving on an Audit Committee, we tend to disagree with this view as we believe that few laypeople are able to scrutinise financial statements from a position of strength.

19.

We support the current principles governing these committees, excepting only that we believe these committees should also appoint the appropriate professional advisors and, particularly in the case of smaller quoted companies, discharge their duties fully as originally intended.

20.

It is difficult to generalise in answering this question. Many companies possess a 'five-year plan' or similar and are proactive in reviewing their collective success against such a document. On an individual level, plenty are rigorous in their application of 360-degree or

comparably rigorous assessment of the ongoing performance of senior executives. But some probably don't do either.

One could argue that these points should form a core aspect of the non-executive role, in that they concern the development of long-term value for all stakeholders. Currently, although non-executives contribute to the development or testing of strategy and intercede should executive performance be found wanting, there is no specific forum for them to review corporate and individual performance.

This underlines why the creation of a formal environment for non-executives to review company and executive performance – we've called it the Review Committee – should be an urgent priority.

21.

We certainly agree that more should be done to review performance – we believe that the proposal to create Review Committees meets this goal. The question of what should be put into the public domain is a difficult one. Information criticising individual directors might weaken their position in dealing with employees, customers and suppliers, while glowing praise might render a star performer more visible, and hence more likely to be headhunted away from the organisation. By the same token, criticism of the board as a whole is unlikely to be helpful to the share price or to employee, customer or supplier confidence in the business. On balance, we believe that a review process is likely to be most useful if it is frank and honest, and this is most likely to be the case if its findings are shared only with those directly affected.

It is difficult to make a qualitative assessment of the performance of non-executive directors in part because the nature of the job is that the greatest contributions are often the least public ones but mainly because there is no executive element to the job it can lack measurable outcomes. However, we do believe that it would be constructive for companies' Annual Reports to record the attendance record of non-executive directors, including the number of times that each sub-committee met during the year in question and the attendance levels of their members. This would create a further incentive towards proactivity.

22.

Non-executives' opportunities successfully to challenge executive decisions or expose serious problems differ widely, based on the informal feedback we have received from a number of serving non-executives. The determining factors seem to be:

- (i) The quantity, expertise and personalities of the non-executives;
- (ii) Their independence from the executive directors;
- (iii) The personality and strength of position of the 'charismatic leader' of the organisation (usually the CEO or Chairman)

The heart of the problem is that, currently, non-executives in the main have only two courses of action open to them if they disagree with the way a company is being run: they can either argue, behind closed doors, with the executives, or they can resign. There's no third party to whom they can complain and who will back their calls for executives to change their ways or step down.

One school of thought is that major institutional shareholders could and should perform this role. This will be discussed in detail in the next section.

D: Relationships with shareholders and others

23.

In many cases there exists no obvious relationship between non-executive directors and shareholders and stakeholders, with all shareholder liaison being the responsibility of the CEO or a Chairman who is either formally or informally non-independent.

In others, there is a genuinely independent non-executive chairman, or senior non-executive director, whose role involves a limited degree of contact with shareholders. Our principal concern is that the discussion channel is largely in one direction: fund managers understandably want there to be an identifiable independent director with whom they can raise any concerns about the business.

It is not clear how often the conversation runs the other way. In other words, do non-executive chairmen and senior non-executive directors feel empowered to pick up the phone to a major institutional investor to raise concerns, request feedback or seek advice about the company? And if they don't, should they?

We appreciate that this is a particularly difficult area, as it raises a number of potential concerns such as creating the potential to privilege one group of shareholders relative to others by providing one group with more information about the business than others. Such information could, in the wrong hands, create the temptation to deal on the basis of such information, which would not at that time have been put in the public domain.

One possibility that has been discussed is that there could be periodic, formal, public, minuted meetings between the non-executives and any shareholders who chose to attend. However we are not sure how frank non-executives could be in such a forum, compared to the informal alternative.

We do not claim to have the answers to this question, though we do feel that the views of fund managers should be sought and considered.

24.

It is hugely difficult to generalise about the activities and performance of Chairmen, because of the wide range of posts whose holders use that title. We believe that a good non-executive Chairman is crucial to the process of ensuring that non-executives can be effective, both in the style of chairing board meetings and in being the main conduit, behind closed doors, between the non-executives and the CEO.

On the other extreme, we are aware – especially in smaller companies – of executive Chairmen, or non-executive Chairmen who are former CEOs of the businesses in question, many of whom are major shareholders in the businesses, who dominate “their” companies to an unhealthy degree. Some of these individuals make it very difficult for conscientious, independent-minded non-executives to perform their roles effectively.

25.

The personal relationships between non-executive directors and executive directors, senior managers and professional advisors should be, in a word, “professional”. That is to say that the non-executives should aim always for human contacts that are polite and engaging, while at the same time maintaining a degree of personal distance in order not to compromise the integrity of their roles. There should be no financial or external business relationships between non-executives and the above groups.

26.

Company secretaries have a crucial role to perform in supporting and promoting effective performance by non-executives in two areas:

- (i) Information flow. This can include not only the circulation of pertinent information well in advance of, and where necessary between, board meetings but also the provision of background information and perhaps the arrangement of induction processes when a new non-executive is appointed;
- (ii) Managing and recording debate. A conscientious and proactive company secretary can assist non-executives greatly, for instance by soliciting and forwarding items for board meeting agendas and calling for clarification of matters when taking notes for the minutes – in some cases, this has been employed as a useful technique in bringing closely-debated matters to a vote, the outcome of which has not always been the same as the “consensus” drawn by the Chairman or CEO

E: Support

27.

Non-executive directors need a wide range of information from management, especially if they sit on the Audit Committee. As far as we have been able to determine, executive directors and company directors are usually responsive to all reasonable requests for information, where it has not already been provided.

28.

There are some very good courses available to assist non-executive directors in performing their duties. We particularly commend those run by the Henley Management Centre. However, while we lack specific data, we suspect that the majority of non-executives have not attended such a program. In the past we have arranged for first-time non-executives to attend an appropriate course as a prelude to placing them with a client business.

29.

We suspect that relatively few companies offer a formal induction program for non-executives joining their boards. This would be simple to arrange and ought to form part of any future best practice guidelines.

30.

We suspect that guidelines on what is expected from non-executives, and feedback to them on their performance, are currently variable in extent and quality. We believe these matters should be the responsibility of a genuinely independent non-executive Chairman, or where there isn't one, the senior non-executive director. However, we believe that these structures are unlikely to be in place in the latter case, where the role is constituted as a less senior position with less of a responsibility for the health of the board.

F: Smaller listed companies

31.

At a number of points in this submission we have been critical of the standards of governance in some smaller quoted companies. We do not believe that standards should be accepted in a smaller quoted company that would be unacceptable in a larger one. This is particularly so when the smaller company sits in the lower half of the senior market, rather than in the junior markets where a cynic might say that the law of “caveat emptor” should prevail.

Clearly, the number of executive directors tends to be smaller on the board of a company having a lower market capitalisation. By implication, a proportionately smaller number of non-executives is appropriate.

However, the quality and independence of those non-executives should be every bit as high because the imperative to ensure that the business is run well, to the long-term benefit of all stakeholders, is if anything greater in a small company where both the risks of the company suffering irreparable damage and the opportunities for significant expansion and hence creation of shareholder value are higher than is the case with a large, established plc.

G: International context

31-33.

The principal alternative models that may be considered when assessing international governance practice are the “dual board” structures prominent in Northern European markets such as Germany, the Netherlands and Scandinavia, and the stakeholder boards seen in the Far East.

We have no experience and hence ability to comment about the latter. Regarding the former, we believe that the operation of separate management and supervisory boards has the significant upside that it presents an opportunity for proper accountability and scrutiny of management, but also that it can introduce a degree of inertia compared to the unitary board model preferred by the UK and US.

We believe that our proposal – essentially to continue with unitary boards with a strengthened and more independent non-executive contingent and more effective and autonomous sub-committees, including a new, non-executive Review Committee – combines the best of the unitary and dual board models.

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