

# **“Non-Executive Directors in Focus - a regime for professional recognition”**

by  
**Dr John Mellor**

Whenever companies get into trouble or corporate governance standards are held up to scrutiny the effectiveness of the non-executive directors is more often than not on the agenda. But where is all this leading? Isn't it time that an attempt was made to pull together the various views and strands of thinking on the role of non-executive directors into a more cohesive and universally understood picture? Or, put differently, isn't it time to work towards professional recognition for the non-executive based on a common understanding of their role and responsibilities.

## **Independent Directors and Corporate Governance**

The first point to make is that substituting 'independent' for 'non-executive' would better convey the essence of the role. Describing the position as 'independent' director highlights a key quality looked for in a holder of the appointment if he/she is to be effective in the interests of shareholders and other stakeholders. It is not meant to imply that there is not a role for 'non-independent' non-executives, because clearly there is and a valuable one too. The important point is that there should be a sufficient number of independent directors on any one board. Secondly, it is important to point out that substance over form in corporate governance is what should matter. In brief, this means the adoption and sensible application of sound values and principles together with shareholders assuming responsibility as owners. There is plenty of evidence to suggest that boards and investors alike still have some way to go in accepting this.

The independent director is increasingly in the spotlight and the pace is unlikely to slacken. Certain 'war stories' suggest misgivings in the effectiveness of some independent directors. Marconi, Enron and BT, to name but three, all fall into this category. They raise queries on the selection process, the independence of those appointed and their capacity to ask the probing questions, and this is far from a comprehensive list. Enron, for example, highlights the possible compromise to effectiveness that could arise from any one person having too many directorships.

This brief glimpse of live situations is evidence enough to suggest that all is not well with the world of independent directors. Indeed some commentators pointed out that this has not been lost on Government. John Plender, in the 4<sup>th</sup> February 2002 edition of the FT, is quoted as saying "The Government wanted progress in developing further the role of strong independent non-executive directors, so expect action here before too long." At the annual Trade and Industry dinner at the Mansion House on 27<sup>th</sup> February the Secretary of State, Patricia Hewitt, announced a review to examine the role and effectiveness of non-executive directors in the UK.

But how can we prepare for and measure effectiveness? Is there not a place for professional standards and continuing professional development as mandatory obligations? What should those standards be? And last but not least, how should investors be involved? What is the essence of shareholder activism in this respect?

## **Effectiveness of Independent Directors**

Let us take a brief look at some of the key issues relevant to the effectiveness of independent directors.

### Role clarity

The role is still undefined. However, to expect a ‘prescription’ that applies to all must be unrealistic, if only because no two boards or sets of circumstances are ever likely to be the same. Nevertheless, reaching a consensus on a framework and guidelines for the role is essential. What we can say is that a framework for the role must include the following important duties and responsibilities :

- Ensuring effective corporate leadership, i.e. an effective chairman and CEO, and being prepared to replace the incumbents if necessary.
- Being involved in development of strategy.
- Ensuring proper governance through effective membership of audit, remuneration and nomination committees.
- Constructively challenging and probing executive decisions.

Independent directors are accountable as members of a unitary board to the shareholders primarily, but with responsibilities on behalf of other stakeholders.

### Preparation and development

Nobody doubts that the role of independent director is professionally demanding and challenging, and that the corporate governance environment is evolving at a rapid pace. All this suggests a requirement for well thought out preparation and ongoing development programmes.

### Limited pool

There is ample evidence to show that independent directors are drawn from a restricted pool, thus limiting the opportunity to bring fresh thinking and judgement to board decisions. The boards of quoted companies have an inclination to dip into the same pool of people serving on similar boards, not least as CEOs. The solution is linked in with preparation and development. Not enough thought and consideration is being applied to expanding the pool, to sources of independent directors of the future, and to preparing and continually developing high quality candidates.

### Selection process

Without a proper selection process the probability of an ineffective appointment must be high. The nub of a proper process should be objectivity with appointment on merit satisfying a well thought out specification.

### Personal qualities

Alongside independence, courage is a key personal quality of the effective incumbent in order to be tenacious in asking the probing question and holding fast to firmly held views.

### Commitment

Being unable to commit the necessary time to any one appointment is perhaps one of the major weaknesses today. It has, of course, implications for rewards and number of directorships.

## **A regime for Independent Directors**

There is a case to be made for establishing some form of professional recognition for independent directors to mark out candidates with suitable experience and of the right calibre.

Based upon reaching a consensus amongst relevant parties and/or their representative bodies on a framework and guidelines for the independent director role, the professional recognition regime would cover the setting of standards to include:

- Preparation for the role by attending recognised programmes of learning. Preparation is not to be confused with induction which, though as important, should be the responsibility of the host company on appointment.

- Ongoing development incorporating keeping up to date with changes in the legal and regulatory environment as they affect the role of the independent director.
- A clear message on the meaning of independence.

Establishing a regime for professional recognition of independent directors to place the role and its incumbents onto a more professional footing in every way should aid the identification of a wider range of suitable candidates and the development of the independent directors of the future.

The Company Law Review recommends “training” and “qualifications” for directors, but we shall have to await the Government’s response before knowing quite what this could mean for independent directors. However, it would appear to be pointing us in the direction of a more professional basis for independent directors. The outcome of the review of non-executive directors announced by the Secretary of State and referred to above will also be interesting to note in this regard. In the meantime and falling out of the Enron situation, a number of relevant initiatives have been set in train in the USA. For example the Council for Institutional Investors, writing to the SEC and Congressional leaders, has recommended as part of a seven point reform programme much greater focus on and clearer definition of independence for directors, whilst Harvey Pitt, SEC Chairman writing to the NYSE and NASDAQ, has raised the issue of continuing education and ethics training for directors.

Clearly there should also be some sensible limit on the number of appointments for independent directors, allowing the time and commitment necessary for each appointment to be satisfactorily executed. This should be accompanied by a compensating increase in the level of rewards.

And finally a way has to be found for better communication between independent directors and investors without undermining the contact with the chairman, chief executive or financial director, so that boards as a whole and investors participate in a shared responsibility for the stewardship of an enterprise.

### **Conclusion - Independent Directors and Investors**

A quote from the Sunday Times on 10<sup>th</sup> February 2002 read “Analysis\* of the performance of the world’s largest 5,000 quoted companies shows that they destroyed \$45 billion of shareholder value in the five years to last June.” (\*Stern Stewart). This figure was struck before the Marconi and Railtrack debacles.

The crucial role played by independent directors in protecting shareholder value is plain to see. Their effectiveness is paramount.

But, as has been shown, there are ‘holes’ in the present model which need to be filled to make independent directors more effective. It is in the interests of investors to encourage and support a regime for professional recognition of independent directors.

Shareholder activism, which must include investors using their influence on board structure and appointments, is therefore to be encouraged, and the legislation proposed by the Government in response to the Myners Review will place this involvement onto a mandatory footing.

But what form might this involvement take? In addition to closer dialogue between boards and investors and the use of votes, perhaps investors should take greater note of the composition of the nomination committee. Making sure, at the very least, that it is composed of a majority of independent directors could be a step towards ensuring the selection of suitably qualified candidates to the board, not least new independent directors.