

# **On behalf of the Non-Executive Director**

**by Dr John Mellor**

As long ago as Cadbury non-executive directors were considered to have an important role to play in corporate governance. This same point is enshrined in the Combined Code, is taken seriously by institutional shareholders and, for good measure, has been once again aired in the recently published Myners report – “more broadly non-executive directors of a company are now placed at the heart of corporate governance”. This presumes, of course, that corporate governance is taken seriously by companies and that it matters to a company’s survival and growth. If this is the case then governance has been accepted as an integral part of life of the company. However, keen observation of the real world would suggest this is far from the case across all companies and that corporate governance is still regarded as a bureaucratic and irritating (!) exercise, unhelpful to getting on with the real job of running a profitable company. This is not, I might add, altogether the fault of companies; shareholders, particularly institutional shareholders as a whole, have their part to play in ensuring that governance is ascribed the level of seriousness and consideration it deserves. Some are doing so, many still remain silent.

But corporate governance is just that; the act of governing a company. According to the Oxford Dictionary definition, govern means to “rule or control (a state, subject, etc) with authority; conduct the policy and affairs of (an organisation, etc)”; and governance “the act or manner of governing; the office or function of governing”. Viewed from this perspective the importance of the role in governance ascribed to the non-executive director becomes real.

Accepting the case for corporate governance and particularly the important part played by the non-executive director, is that the end of it as far as non-executives are concerned, or is there a need to explore further and challenge the current state of affairs?

## **The non-executive role**

Explanations or descriptions of the role of the non-executive have been attempted in a variety of written forms – books, articles, academic papers, statements of corporate governance policies, and even Codes(!), and no doubt these writings have been matched by endless discussions. But 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. However, as yet there appears not to be a consensus amongst company boards, shareholders and non-executives themselves on a set of elements to provide a framework for the role to give guidance, not only to those new or less experienced but also to those who have held non-executive positions for some time. Too often the cry goes up “where were the non-executive directors” or “what were the non-executives doing” when news breaks, sometimes unexpectedly, that a company’s circumstances have seriously deteriorated causing a significant loss of shareholder value. A survey last year by Price Waterhouse Coopers<sup>1</sup> which included discussion with business leaders on the core elements of the non-executive director role, showed

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<sup>1</sup> “Non-Executive Directors : A survey of practice and opinion (June 2000)

agreement on only two elements (contribution to strategy and ensuring the company has the right chief executive) out of four. It is generally accepted that the non-executive director role is a demanding and difficult one. Reaching a consensus on a framework and guidelines for the role would be a helpful step in support of the non-executive director. A major aim of *nedforum*<sup>2</sup> is to clarify for people the nature of the role and to propose guidelines to steer them in the execution of their responsibilities. These guidelines are drawn from keen analysis of case studies and debate with experienced practitioners and professionals. But there are other critical issues which require attention or, where progress is already being made, for that progress to be accelerated.

#### Four key issues

- i. There is ample evidence to show that non-executive directors are drawn from a restricted pool, thus limiting the opportunity to bring fresh thinking and judgement to board decisions. Take for instance the boards of quoted companies which have an inclination to dip into the same pool of people serving on similar boards, not least as CEOs. Is enough thought and consideration being applied to expanding this pool and, as important, to the sources of the non-executives of the future?
- ii. However, there are signs of another problem emerging. There is evidence to indicate reluctance amongst some high quality candidates to being appointed non-executive directors. The grounds for this reluctance appear to be potential personal liability, reputational risk and, significantly, an imbalance between the demands of the role, commitment and reward.
- iii. This naturally leads into a third important question. Is enough being done to prepare and continually develop high quality candidates? Some organisations (the *nedforum* is one) provide courses or programmes for non-executive directors, but this is still a young “industry” with a long way to go in support of non-executives.
- iv. A key issue still to be tackled is selection. Without a proper selection process the probability of an ineffective appointment must be high. The question is, therefore, to what extent is selection of non-executives on merit to match a well thought out specification replacing other less objective processes? The evidence would suggest that the answer is slowly. Many companies still do not take selection of non-executives nearly seriously enough. This is inconsistent with the importance of their role.

To all the above must be added consideration of those changes in the legal, institutional investment, political and business climate which are beginning to have, and will increasingly have, a bearing on the non-executive director role. This points up the case for continuing professional development in support of the non-executive for him/her to be effective in a changing environment. At the same time such

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<sup>2</sup> The Non Executive Director’s Forum

consideration is a pointer to the skills, knowledge and experience required in non-executives not only now but also in the future.

### The changing role

Two key drivers of change which will have an impact on the role of non-executive directors are the reform of Company Law and the review of Institutional Investment in the UK by Paul Myners, Chairman of Gartmore Investment Management. The review of Company Law set in motion by the DTI in March 1998 is due to reach its concluding stage for presentation to the Government in the summer of this year. The Myners report, initiated by the Treasury, has already been delivered to the Chancellor.

At the opening of this Parliamentary session the Government announced the inclusion of an Enterprise Bill and, in a document “Productivity in the UK : Enterprise and the Productivity Challenge”<sup>3</sup>, the Chancellor and Secretary of state for Trade and Industry explained the detail of their initiatives including the following intentions. On Company Law there will be “comprehensive modernisation of Company Law following the final report of the Independent Company Law Review”, with a White Paper to be expected; and on Myners a statement to the effect that the findings of the report were accepted in full and that the Government “has held a short consultation on the detail of a set of principles of a code for investment decision making. Its conclusions will be announced in the coming months.”

It is clear that we may expect a new Companies Act and proper understanding of the implications for the non-executive will have to wait until then and until the Government’s response to the complete range of issues raised by the review. However, as a preliminary indication two observations are relevant. There is a recommendation to provide “a statement of directors’ duties, including an inclusive duty of compliance and loyalty restating and clarifying the present legal position that companies should be operated in the ultimate interest of their members, but subject to their constitutions and taking account of all the relevant considerations, including the implications for the company of the directors’ decisions over time and of their wider relationships and impacts.” A second recommendation is for the Combined Code in its entirety to be given more time to work in practice, but that a more positive approach be taken to its application. This is a reaction against ‘box ticking’ and an urge for companies to adopt and be seen to be adopting best practice to head off any moves to legislate.

A relevant observation on Myners (aside from a re-emphasis of the important role non-executives play in governance) is the recommendation on shareholder activism, specifically incorporation of the US ERISA (Employment Retirement Income Security Act) principles into UK law, making intervention in companies, where it is in shareholders’ interests, a duty for fund managers. ERISA makes clear the duties of managers to intervene in companies – making use of their votes or otherwise – where there is a reasonable expectation that doing so might make a positive impact upon the value of the investment. Strong reservations about strategy, people or other potential causes of underperformance would usually be the basis for intervention. Increasing the level of shareholder activism raises three signals for non-executive directors.

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<sup>3</sup> Available from HM Treasury

They are: more communication between them and fund managers, and more interest by managers in their suitability for appointment and their performance as members of the board.

In considering the changing political and business climate, self evidently there is a fundamental drive for greater transparency in company reporting and accountability from directors. Accountability applies as much to the non-executives as to other colleagues on the board. Chairmanship of key board committees (audit, remuneration, nomination) is a component of this. Complexity in business, be it manufacturing or services, including the professions, is also on the increase, not least because of globalisation and the impact of technology, causing significant and in many cases rapid change in some sectors. This complexity can lead to a difficulty in seeing 'the wood for the trees', placing a premium on the ability to take an holistic and forward thinking view, essential to the leadership of any enterprise. The non-executive director is in prime position to contribute to this endeavour.

### Conclusion

This review and discussion of non-executive directors and their role leads to one unavoidable conclusion - that this important role is a demanding one professionally. This applies to both the quality of candidates as well as to the execution of their responsibilities. It requires commitment of significant amounts of time to meet the demands of any particular position, satisfy the expectations of shareholders and last, but not least, to keep up to date with evolution in the corporate governance field. What follows of course is the question of how many non-executive positions an individual can reasonably expect to hold in order to be properly effective in any one of them. At the same time this raises the question mentioned before of what levels of remuneration for non-executives are needed to strike an acceptable balance between reward and commitment. For the moment there is evidence to suggest that non-executives are underpaid for the demands placed upon them.

To accord with the importance of non-executives in the governance of companies issues remain to be addressed on their behalf. Some are fundamental, such as preparation and a consensus on a framework for the role. Others, such as continuing professional development, including keeping up with a changing environment, are ongoing.

These are challenging times for the non-executive director.

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