

ACT'S RESPONSE TO HIGGS

THE ASSOCIATION HAS RESPONDED FORMALLY TO DEREK HIGGS' RECENT CONSULTATION PAPER, TAKING A STRONG LINE ON INDEPENDENT BOARD REPRESENTATION. A SUMMARY IS PUBLISHED BELOW.

Improving corporate governance in the UK is now much more a question of people and attitudes than new regulation. We do not believe that the UK model of corporate governance is broken: we do not know of a better model elsewhere in the world. Codes of best practice and an atmosphere of general comment and interest from the community at large, without obsession, remain the way forward. Good people are required to make any system work well, and can greatly improve the working of bad systems. The wrong people can cause major difficulties within the best of structures. We suggest ways in which numbers of good, independent, non-executives can be increased.

SUMMARY.

Non-executive directors' main roles are those of strategic support and monitoring of management – executive directors – in a unitary board. Their independence from important potential conflicts of interest which can affect executive directors is fundamental. We set out many examples of such conflict of interest. What is required to be independent will evolve over the years. We suggest some ways of refining of the concept which would be helpful now.

We suggest attitudes and practices which would improve the effectiveness of company chairmen, who should be numbered among the independent non-executive directors. The latter need to be in sufficient numbers (a simple majority of the board) and to have the firmness of purpose to require suitable information flows from executive management. They must give the time to understand, and bring an ability to use, the information provided. Companies need to invest in supporting and developing the abilities of their non-executive directors if they are to get the best out of them. We highlight one key area in which most non-executives need education if they are to be effective.

The number of non-executive posts a person can hold is very limited. Persons in full-time work probably cannot take on more than one non-executive directorship – and that only with the cooperation of their employers/firms.

Non-executives need adequate reward for their time and skills but moderation in total reward and avoidance of some forms of remuneration are required if they are to be truly independent. For

this reason, the potential financial liabilities which they incur from their position must be limited – if they have acted in good faith, with reasonable diligence, and not recklessly. It is neither practical nor desirable to protect them from the reputational risk of involvement with a company.

We highlight some problems with the proposed code of directors' duties included in the recent draft Companies Bill, although in principle such a code can be a useful tool.

No group of non-executives, however independent, skilled or diligent, is able to protect against a management which is resolved to conceal or mislead.

GENERAL COMMENTS

The consultation paper asks in places for instances or company experiences. While the Association in its consultations is aware of many, the circumstances would too often identify the particular company, and hence individuals, and so none are quoted. We have included some discussion to give the rationale or background to normative comments.

THE GENERAL FRAMEWORK FOR NON-EXECUTIVE DIRECTORS.

The Association believes that, in general, the framework of regulation and the Combined Code, supported by best practice advice, is working well. The current system is relatively new and its adoption becomes more effective and less cosmetic with the passage of time and as people become accustomed to it. We do not advocate new regulation in general, but do suggest improvement of best practice recommendations in some cases.

ACCOUNTABILITY OF COMPANIES. Many commentators have referred to the accountability of companies to shareholders especially among a wide range of stakeholders. However, for the purposes of our comments we focussed on two accountabilities, whether legal or moral:

- accountability to shareholders, as owners of the company
- accountability, arising from the company's use of the privilege of limited liability, to others dealing with the company or to whom it may incur liabilities.

□ MAIN POINTS AND RECOMMENDATIONS

1. REGULATION/BEST PRACTICE CODES. We do not see a need for new regulation in general, but do suggest improvements to best practice recommendation at several places

2. UNITARY BOARDS. We support the unitary nature of the board of directors.

3. RISKS. Director appreciation of risk issues is vital. A key responsibility of a company's board is to ensure that the overall risk in the company is controlled and remains within the range the board has selected – and that significant changes are made known to the market and the public generally.

4. UNITARY BOARDS. Within the unitary board we believe that the position of independent non-executive directors is important and we would toughen the detailed codes on what prevents true independence. We believe that independent non-executive directors should constitute a majority of the board.

5. CHAIRMEN. The Chairman should be numbered among the independent non-executive directors. The exception in the Combined Code permitting the roles of Chairman and Chief Executive to be combined should be abolished.

6. DIRECTOR INDUCTION/TRAINING. All directors should be introduced to their responsibilities as directors – legal and under the various best practice codes – on first appointment. A qualified company secretary should keep them updated of changes in the requirements. Non-executive directors should also have a programme to familiarise themselves with the company and its risk environment. Few directors do not need some education about risks and dependencies in any projections of the future and how the overall risk in the company can be managed.

7. A SECOND SENIOR NON-EXECUTIVE DIRECTOR. It is important that there be a nominated senior independent non-executive director apart from the Chairman. This would normally be the Deputy Chairman.

8. TIME COMMITMENT/LIMITS ON NUMBER OF POSITIONS. Directors must limit positions in the light of time available:

- Chairmen. It would be difficult for a Chairman to chair more than one other unrelated company or, alternatively, to have more than a couple of non-executive posts on boards of non-related companies. The ABI/NAPF code should be adapted accordingly.
- Someone in substantially full-time employment cannot give sufficient time for more than one, unrelated independent non-executive directorship.
- Other independent non-executive directors must be guided by circumstances, but we believe the NAPF guidance of a maximum of 5 concurrent appointments is generous.

9. NON-EXECUTIVE ROLES. We do not advocate different roles for different non-executives, the Chairman and Deputy Chairman apart.

10. BOARD COMMITTEES. All independent non-executive directors should be entitled to attend any meeting of any committee, even if they are not actually a member of it. The Association would urge that the Combined Code stipulations for non-executive director membership of specified board committees be changed to specify independent non-executive directors.

11. INTERNAL AUDIT. We believe that the relationship between the Audit Committee and internal audit function should be strengthened.

12. NON-EXECUTIVE REMUNERATION. Non-executive directors' independence can be destroyed by issuing them with options or schemes which vest shares or grant shares or material bonuses dependent upon company reported performance and/or share price. Codes of best practice should deprecate use of such forms of remuneration.

13. EXECUTIVE DIRECTOR REMUNERATION. The Association supports the right of shareholders to vote on contracts (including remuneration packages of executive directors).

14. RISKS. Non-executive directors need indemnities from the company and also to be included in the company's 'Directors and Officers' policy. They need the availability of "top-up" policies. Much further study is needed of the possibilities of limiting personal liabilities to realistic levels.

15. PROPOSED STATUTORY STATEMENT OF DIRECTORS DUTIES. We believe that, subject to some important re-drafting, the statement can be helpful. As regards benefits from third parties, we believe that if regulation is required, it be confined to requiring companies to adopt and publish a code of practice to be followed by directors.

16. SKILLS, QUALITIES, EXPERIENCE OF NON-EXECUTIVE DIRECTORS. The Association believes that the personal qualities of candidates are the key and generally more important than particular expertise. We make a number of important observations about expertise required.

17. WIDENING THE POOL OF POTENTIAL NON-EXECUTIVES. Regular public comment from institutional investors or the bodies representing classes of them about the need to recruit more widely is probably the fastest way to free up the situation and extend the search. Attitudes of recruitment agencies are the biggest stumbling block. Divisional or large subsidiary company boards or the policy making groups of particular functions in large multinational companies, or the boards of not-for-profit organisations are useful areas for prospecting. As independent non-executives are to bring a broad, balanced judgement, stakeholders as such are not suitable candidates – though individual stakeholders may be. Greater international representation on UK boards is only a marginal contributor to widening the pool of potential non-executives.

18. INTERNATIONAL LESSONS ABOUT BEHAVIOUR OR STRUCTURES. We believe that the UK system of corporate governance, with unitary boards, which meet frequently and include independent non-executives, is inherently potentially superior to other models.

THE POSITION OF PROFESSIONALLY QUALIFIED MEMBERS OF THE BOARD AND OF OTHER PROFESSIONALS EMPLOYED BY THE COMPANY. Members of professional bodies related to corporate governance and finance are governed by the professional code of those professional bodies. Such bodies usually have provision for “continuing professional education” after members’ initial examinations, and an appropriate ethical code.

High standards of conduct and knowledge of legal and regulatory requirements and generally accepted ‘best practice’ can thus be expected from such members. In the current context, as the courts will consider the general knowledge, skill and experience that a director has, they will look for high standards in these areas from relevantly qualified professionals who are directors.

Professionals generally are expected to be more aware of potential or actual conflicts of interest – for themselves or for colleagues – and of possible enrichment or other misconduct or conflict of interest by those around them. Commentators on the recent corporate scandals in the US have drawn attention to the general failure of ‘professionals’ at board level and below in the affected companies either to refrain from malpractice themselves or to ‘blow the whistle’ on others. We note that the preponderant majority of the equivalents of finance directors of US companies, in the main, are not members of professional bodies.

It is very important that arrangements and structures in a company right up to board level support and give mechanisms/channels for professionals to take correct action in such cases. In the UK many companies have such arrangements and it is best practice. Non-executive directors have a potentially key role in this context. This is discussed at several points in detail in the formal response.

THE ‘CRUCIAL ROLE’ OF NON-EXECUTIVE DIRECTORS. Paragraph 1 of the Introduction of the Consultation Paper refers to the wide recognition of the crucial role of non-executive directors. We would like to believe this to be true, but are aware of scepticism today in many quarters.

Institutional shareholders were slow to pressure companies to follow the Cadbury and later codes, but they seem more active today. They need to press non-executives to be effective in their role and not passive ‘free riders’.

Support for the role tends to be based on a theoretical reasoning and anecdote. Some soundly based academic studies investigating if independent non-executive directors do actually improve company performance and accountability, over the long term, would be welcomed.

COMPANIES. The Review terms of reference, Appendix A, refer to companies generally, but the discussion which opens the Issues for consideration section refers only to listed companies. We believe that the principles of the Combined Code¹ and those we set out in these comments set the standards for all corporate enterprises. The Schedule to the draft Companies Bill which sets out general principles by which Directors are bound applies to all companies, of course.

The full response can be accessed via ACTonline at www.treasurers.org/treasury_resources/ACT_Higgs_Response.pdf.

Note 1: The Combined Code: Principles of good governance and Code of best practice, May 2000, derived by the Committee on Corporate Governance from the Committee’s Final Report (Hampel Committee Report, January 1998) and from the Cadbury and Greenbury Reports (December 1992 and July 1995).