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The Non Executive Director Transcript

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The Non-Executive Director

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I now turn to the third in my series of lectures on governance, the first two being on The Board and 'The Chairman and The Chief Executive. I begin by re-emphasising some relevant points that I made in the first lecture, without going over the debate again. Indeed I believe that in the general discussion that followed the lecture these points represented the consensus of guests and those of the audience who participated. It is however important to add that these are guidelines and not hard and fast rules, for the circumstances and purpose of the organisation will vary. They are most appropriate for mature quoted plcs, but they have relevance to every organisation, plc, co-operative, public sector, charitable or otherwise not for profit, which has a board of directors, trustees or governors. I shall for ease refer to the latter as directors.

- Boards should concentrate almost exclusively on strategic matters, and making sure that the right people are in place to carry out their decisions.
- Boards should regularly review their own performance and their members, including the Chairman. The performance of NEDs should be appraised just like any other member of management.
- The Board should regularly review its own governance procedures, and stick to the ground rules it sets itself
- Boards should never exceed 12 in number with balanced numbers of non-execs and executives, with an optimum around 8. NEDs should bring specific and useful skills to the table.
- The overriding duty of the Board, apart from statutory requirements, is to look after the interests of the shareholders. Benefiting stakeholders supports this objective but is not sovereign in its own right

I shall weave these points into my remarks, but I will focus first on the role itself. It is vital to realise that in one very important respect all directors are equal and that qualifications to the office of director - 'non-executive' or 'executive', 'independent' or 'non-independent' - are not relevant to the central functions of the position: always to act in the best interests of the company and the shareholders.

Objectivity and independence

This leads me to a major theme of this lecture, and one upon which the spotlight rarely falls. A director's responsibility is not just a by-product of the emergence of the capitalist system and accompanying rise of the joint stock company. There is a genuine requirement for objectivity, and where required of selflessness implied in leaving personal interests behind. It could even be said that there is an element of public service in the role of a director of anything other than a closely held, relatively small private company.

It is this requirement of objectivity that is, frankly, the most breached of all such rules. In most cases it happens behind closed doors, and often in the bosom and mind of the director, but in so many cases it is plain for all to see. The best and endemic example is of corporate mergers or takeovers where at one extreme it is plain that they have failed quite simply because of ego, because the personal interests of the respective Chairman/CEOs/Directors have prevented board and executive structures which would have been in the best interests of combined shareholders. At the other extreme such mergers and takeovers have actually taken place in profusion because of the ambition of one or more people, and well beyond the rational interests of shareholders.

I have often heard it argued in defence of these situations that such mergers are indeed about people and there are even instances of megamillion takeovers supposedly instigated to acquire the talents of just one individual. Even at today's levels of executive remuneration it is hard to see how it is not cheaper merely to go out and hire the paragon. But at the end of the day it is the strategic rationale - regardless of the individuals in the boxes on the organisation chart - that must be paramount. If the rationale is faulty the results will be unpredictable and shareholder value potentially diminished, however talented the participants. The principle behind this is that the corporation is more powerful than the individual.

It is for this reason as much as any other that the notion of a so-called independent non executive director has arisen - one who is as far as possible likely to be untouched by conflicts created by executive position, by specific shareholder interests, or by a personal shareholding, one who is most likely to be objective in his judgement. Given human frailty it is a notion that I support, and it is on the role of this individual that I shall concentrate.

Review of performance and term of appointment

Some special interest group pursue vociferously and indeed pester boards with the assertion that an NED who has served more than 2 terms of three years is no longer 'independent'. The argument seems to be that they will have in some way grown too close to the management or - to avoid a very unPC term - have in some way sided with the indigenous population. In contrast I have served on boards where if anything the longer serving, but putatively no longer independent directors have grown more farsighted and objective as time has gone on. The proposition ignores continuity, industry knowledge and indeed the natural accretion of wisdom that comes with age and experience.

But it does recognise, in my view correctly, that the effluxion of time may cause individual NEDs to lose their edge, that some may indeed have begun to camp in the executive kraal, and perhaps most importantly that there is always a need for reinvigoration and stimulus of fresh eyes and new vision created by a slow but steady turnover of NEDs. But there is also a need for a better mechanism than automatic re-branding.

In my immediately previous lecture I argued that the continued employment of Chairman and CEOs should be reviewed more often and more rigorously, after 5 and 4 years respectively. I would submit that a better approach to long-serving 'independent' NEDs is not to re-brand them, but to subject them to tactful, discreet, but firm review on at least a biannual basis, and, although this is entirely a matter of subjective judgement, commencing at the point at which the company and they would be committing to a third term. The review could be undertaken by a combination of the senior NED (an appointment which I regard as critical) and the Chairman, unless it were the review of either of the latter themselves. It may seem at first to be an embarrassing and personally challenging process, but if all concerned understood that it was to take place from the outset, it would become acceptable.

Are personal equity stakes and options acceptable?

It is understood and correct that the representative of or the personal holder of a substantial block of shares will usually be sufficiently conflicted not to be considered independent. There is, extending this notion to its ultimate limit, a school of thought which suggests that any shareholding at all creates a conflict and reduces objectivity. I think that there is a degree of logic and merit in this argument, but against it is the fact that generally speaking institutional investors like to see a financial commitment to the company in the form of a shareholding from all directors, and it does send a message also to the company and its employees themselves. The personal financial position of NEDs is no doubt extremely varied and the sum of say £100k may be a very significant amount to some, but as it were a groat to others. The approach that I would suggest is that NEDs should certainly take a shareholding but that it should never be so high as to be a meaningful part of their personal net worth, sufficient to cloud the objectivity of their judgement - as a rule of thumb say 10%.

There is an interesting and increasingly common conflict with this proposal which arises in the context of higher risk ventures. The latter may, prior to IPO (Initial Public Offering or 'quote'), issue NEDs with shares or options to conserve cash and give the NED a share in the upside for taking the risk of associating his name with the business and because of the (presumably) high quality and greatly needed advice he will provide. This in itself may not give rise after IPO to the suggestion that the beneficiary has as a consequence lost his independence, unless the resulting holding or potential holding (as a result of option exercise) is significant in relation to the actual or potential issued capital, or, again, represents a significant part of the NEDs net worth - as in many cases it may.

I certainly do not believe that issuing options to NEDs post IPO is appropriate. Such options are now the norm for executives, awarded for achievement and increasingly with exercise dependent on further achievement; the tests are rigorous and generally relate to targets set objectively by the board. They are intended as both an incentive and a share in the wealth putatively being created by the executive. There are in my mind three major reasons why such remuneration should not be offered to independent NEDs. First as the independent members of the Board they should be able to take an objective view of the appropriate targets and relative performance of their executive colleagues; they are obviously conflicted if they too are beneficiaries; second they should not need such an incentive, being appropriately paid for the job that they do; and in many cases giving them significant levels of options may breach the concept that their interest in the relevant company should not become too high a part of their personal net worth.

Problems of 'representing' large shareholders

It is also clear that NEDs who sit on boards as the nominees of large shareholders can be particularly prone to tussles with objectivity, and are therefore indubitably not candidates for independent directorships. It would be almost superhuman (although it is a feat that is, miraculously, occasionally performed) for them to return to base and say that they voted against the interest of the nominating shareholder because they felt it to the general benefit of the company and shareholders as a whole. What is not so obvious is the conflict experienced by directors who are elected to a board, most probably that of a co-operative, whose employers often expect them to stand up for the latter's corner even if, to the director's eyes, it is the wrong direction for the institution. When I was at LIFFE, whilst we took some pains to point out to member-elected directors that they had a duty of objectivity, many such directors found their personal conflicts quite intolerable. I am certain that much of the difficulty we had in gaining a consensus on strategic direction, particularly in respect of electronic trading was due to these heavy tugs on loyalty and objectivity. What is particularly noteworthy is that whilst I am certain that a number of my board colleagues could on this account be guilty of a theoretical breach of fiduciary duty, I am equally certain that most if not all would not have seen it that way. The lesson to be drawn is that there are many situations, and not just the obvious, prescribed ones, that can lead to loss of independence.

But the latter anecdote has a positive side. My then Chairman and I saw the problem of lack of board objectivity very early in my tenure, and set about appointing a small number of genuinely independent directors. The process of convincing first the existing board and then the members as a whole took the best part of a year, but we did find two quite outstanding candidates, of whom one is my guest tonight. Sparing his blushes, it is unanimously agreed amongst those who were involved in the events of those times, that without their courage, perspicacity and wisdom, we would never have achieved the reforms that have led to the revival and renaissance of the exchange. Certainly my own position and that of my chairmen would have become totally untenable. Their contribution, which must in detail remain behind closed doors, was absolutely critical.

Criteria for success

I turn now to the role itself. At its heart is to ensure that board decision making is of the highest quality, that the right executives are in place, and that the stakeholders interests are always paramount.

What are the personal requirements for success in the job? Extensive and, importantly, up to date business and/ or administrative experience, maturity and good judgement, together with a dash of steel, independence of mind, courage and willingness to stand one's ground and be counted when vital principles are at stake, but nonetheless a team player, all these are given characteristics. To these I would add a sense of duty, and willingness to give whatever time is necessary in rare, but important corporate circumstances. The irony is that these virtues, and particularly that of being abreast of modern business thinking and techniques, are most often found in those who are in mid-career, with a demanding fulltime position elsewhere. There is undoubtedly a time decay factor for older NEDs, who are in the afternoon of their working life, and who make up a considerable portion of the boards of for instance quoted plcs. There are some very notable exceptions, shrewd and wise, but boards would do well regularly to review the positions of NEDs who are for the most part retired or significantly winding down. I well remember sitting as an executive on the board of Unigate with a marvellous ex-diplomat called Sir Con O'Neill, who came unwillingly to fame for standing up to George Brown at his most tired and emotional. I don't truly know what his real contribution was, apart for the inspiration of what we called 'The Con O'Neill test for board papers' ie could they be understood and absorbed by a highly intelligent but non business oriented former civil servant; and for his parting words which were that he felt he had 'filled a slot and caused no trouble'. I have even sat on boards where members have slipped gently into slumber from time to time, not always observing the golden rule that it is best when waking up from a brief zizz to keep the eyes closed, pick up the thread of the conversation and then make a brilliant interjection, eyes still closed, so that colleagues are gulled into believing that there is worth in the old boy after all. It is of course important for NEDs to keep abreast of corporate events, to get to know the senior people, and to understand the industries of companies on whose boards they serve. But it is in my mind very important to realise that it is in the first period of their tenure that they will be likely to make the most impact. This requires the ability to undertake a steep learning curve, but it addresses the fact that first impressions are also often the most accurate, that fresh eyes can bring new and valuable insights, with different lines of bearing from those who are familiar with and integrated into the activities of the company. It also provides the NED with a key once only opportunity to review for himself the governance procedures of the company, the workings of the board and its committees, the style of the Chairman, the CEO and the other executive directors, as well as his NED colleagues, and the quality and appropriateness of information and papers which the board receives. It is much more difficult to suggest changes or at least put down markers after more than say a year in the job, when the NED has become more used to the procedures, and has perhaps started himself to have more sympathy with the indigenous population.

Availability for the unexpected

There is also the contingent element of an NEDs responsibilities which is usually overlooked and is in my mind potentially the most important part of the NED's service to the company. From time to time special circumstances will arise which will require extra attention - major takeovers either as acquirer or target, major strategic events, such as demergers, failures of strategy requiring drastic reappraisal, management reorganisations leading to CEO/senior executive changes. It is in the time leading up to and during these events that the experience and judgement of NEDs, and their objectivity, with company/ shareholder interest always to the fore, will arguably make their greatest contribution. Indeed it is as often as not the NEDs themselves who may take a more proactive role and trigger the analysis and discussion which leads to the events themselves. Every NED should be prepared and be in a position to provide his time and wisdom instintingly at these key extracurricular moments. An NED who is too busy, or not paying close enough attention to the institution's affairs, is not worthy of the job.

Beyond this a non-executive should be available for advice to the Chairman and the Executive, not just in general terms, but also in relation to the specific discipline, eg IT or marketing, which may be his or her core skill. This can be provided proactively, where specific circumstances allow, or reactively when a need arises for the executive board or senior board members. It is often forgotten that NEDs, if properly chosen and functioning effectively, can represent a wealth of knowledge and talent that can add an extra dimension and depth to executive decision making. But it is also important that an NED should not attain too executive a role. His principal job is strategic and his involvement in day to day operations should be sparing and specific, based on temporary requirements. Aside from his own review, which I described above, it is essential that he takes an active participation in reviewing the senior team. The annual set piece for this will be the Remuneration Committee, but he should be working with the Chairman constantly to evaluate performance on an ad hoc basis, and lending help and advice where that will improve the situation. And of course he must not lose sight of the fact that he has a responsibility to ensure not only that the correct management team is in place, but also that the Chairman is up to the job. It is a salutary fact that Chairman tend to resign for under-performance reasons much more often than CEOs. Can it be that they are to that extent on average better than CEOs, or is it that NEDs feel more constrained in taking drastic action against a Chairman? What is certain is that the Chairman's role is complementary to, but at least as important as that of the CEO.

Pay and public service

I want now to reintroduce what I see as the public service element of an independent NEDs role. It is significant in this context that many senior private sector executives are attracted to public service type jobs (eg in public sector or non - profit making institutions) at pay much less than and often a fraction of their existing package. The attractions of the NED role are extensive, but they not to be connected with remuneration, and indeed a very large portion of full time executives pass their NED fees back to their employers. I certainly did when I was at LIFFE. This and the public service concept argue for fees that are fair but do not necessarily bear any resemblance to the per diem rate that an executive might command as a consultant in the private sector, as is often argues. It is fantastic to me that an NED of a top hundred company, presumably with a seat on, say, the Audit Committee and Remuneration Committee can trouser £45k to £50k for what is in reality a longish day's work a month - a per diem rate of £4,000. The fact is that most of these people would be prepared to join such prestigious boards for half the pay, and many in effect do it for nothing, since their companies keep the cheque. The cynical would also be tempted to wonder what the value for money might be, with the seemingly never-ending parade of board level governance failures. It could also be argued that significantly lower rewards might put more perspective into the deliberations of Remuneration Committees, and certainly give them the moral high ground. What is the appropriate level of pay for an NED? Clearly this depends on the size of the company and the likely time commitment, the latter for instance being determined by committee requirements, such as Audit or Remuneration, and is usually conceived as a day a month. In my mind there are three components: actual time expended in normal times plus an insurance premium for availability in exceptional circumstances if required, less an element to indicate the public service element of the job. One could argue that the latter offsets the former. People with the calibre to sit on public boards will probably command personal chargeout rates of between £750 and £2,500 per day, and the rate of pay will clearly be determined by the size of the company and/or the relative remuneration of its executive directors. Simple arithmetic suggests therefore that the going rate for an NED, including some additional time availability if required, should be between £9,000 pa and £30,000 pa.
Spreading the net wider
Finally, I have often heard it said that it is difficult to find good NEDs, but it is also my experience that there many executive members of plc boards, and indeed of the boards of major subsidiaries of the larger corporation who aspire to one or two interesting non-executive roles, outside their current job. Observably many would do the job very well, and their wider experience would benefit their employer, indeed the more enlightened larger companies have experimented with such placements, although not usually on plc boards. An often voiced objection is lack of board experience, but that can hardly apply to those already on plc boards, and it is also true that major divisional boards often go about their business considerably more professionally and effectively than many plc holdings boards. I wonder whether the mechanisms for selection - usually network/word of mouth, dedicated not for profit organisations, or head-hunters - are spreading the net wide enough. It is observably true that many institutions are not fully served by their NEDs, certainly by the demanding standards that I have set out above. I believe that there is a significant and substantial cadre of untapped ability out there which could grace and enhance the proceedings of boards which badly need it. Is it time to review and take a more radical view of the methods of those involved in selection and the population of talent which over which they cast their flies?

My main points again:

- All directors are equal in their overriding responsibilities to company and shareholders, but independent NEDs should above all bring objectivity to boardroom discussion, and ensure that the right executive team and Chairman is in place
- NEDs performance should be reviewed regularly, but two terms should not necessarily be the limit of their tenure, and there should be a focus on those who are retired or 'winding down'
- NEDs should have shareholdings, but not so large in relation to their own net worth as to cloud their judgement
- NEDs may be able to receive options pre IPO in higher risk ventures, but definitely not in quoted companies
- A key responsibility for an NED is to be available for one-off strategic situations and events, regardless of other commitments
- An NED is potentially at his most effective during the first year of his first term
- There is a public service element to the NED role and in some cases NED's pay looks to be on the high side
- There is an untapped cadre of potential non-executive talent, particularly executive members of plc and major divisional boards, which could and should be unlocked for the benefit of plc governance as a whole