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THOUGHTS ON CORPORATE GOVERNANCE

I have been chairing a committee on the financial aspects of corporate governance since May of last year and this has given rise to thoughts on wider aspects of the matter. I will only refer to the work of the Committee which is described in detail elsewhere in this journal, but it has focused specifically on issues arising from the standards of financial control and reporting in Britain.

It is, however, significant that, although the Committee's terms of reference were tightly drawn, its proceedings have attracted an unexpected degree of press attention. This reflects the widespread interest in matters of corporate governance, both here and in the United States. In this countrv, that interest has been fuelled bv some notable company disasters and by controversies over boardroom pay.

As a result of this public interest in company affairs, the Committee has received a remarkable and heartening response to its request for comments on its proposals. On the other side of the same coin, there has been a tendency to lose sight of the fact that the Committee is enquiring into the financial aspects of corporate governance, not corporate governance itself.

BASIS OF COMMITTEE PROPOSALS

The Committee has put forward practical ways of raising financial control and reporting standards, which could largely be put into effect without waiting for legislation. The Committee's recommendations are based on current best practice and are aimed at strengthening the present system of corporate governance, not at replacing it. Although we have concentrated on matters relating to financial reporting and accountability, the principles on which I believe the Committee's proposals are based are capable of wider application in the governance field.

I should explain at this point that I am here expressing my personal views, which should not be held against the Committee! In my view, the Committee's approach to raising corporate standards has been based on a number of general principles. These include the need to tighten accounting standards, to clarify responsibilities, to encourage full disclosure, to strengthen the influence of shareholders and to build the necessary checks and balances into board structures.

I will leave on one side accounting standards and the clarification of responsibilities, important though they are in the governance context, because they were specific to the Committee's task. The other three principles seem to me to be relevant to the debate on how to raise governance standards in Britain and in the United States. In both countries the concern centres on the effectiveness and the accountability of boards. To an extent the two go together. The more acutely boards feel accountable, the more demanding are likely to be the goals which they set for themselves.

DISCLOSURE

Disclosure is clearly central to accountability and indeed to public trust in the corporate system. I see the trend towards greater openness by the company sector as both right and inevitable. The dilemma for companies over providing more information about their affairs is that they are necessarily complex. It is, therefore, hard for them to strike the right balance between comprehensiveness and comprehension, as the detailed disclosure of directors' pay has shown in the United States.

Nevertheless, directors are going to have to continue to work at presenting their companies' activities even-handedly and intelligibly and the wide range of users of company statements at gaining a greater understanding of how to interpret them. Disclosure will remain a basic plank of any proposals for raising corporate standards.

SHAREHOLDERS

Similarly, I would expect the strengthening of the role of shareholders to feature in any recommendations for improving corporate governance. Monks and Minow's magisterial review of the state of play in the United States, "Power and Accountability", describes how the earlier accountability of boards to shareholders and of both to society has been eroded. Their remedy is to restore power to shareholders and they look particularly to pension funds to bring effective accountability back to the governance system.

There is a similar move in Britain to encourage shareholders to see themselves as owners, rather than as traders, and to take a direct interest in better governance. Our Committee has warmly welcomed the lead which the Institutional Shareholders' Committee has given in its recent publication, "The Responsibilities of Institutional Shareholders in the UK", which encourages institutions to have regular contacts with companies, to use their votes and to take a positive interest in the composition of boards of directors. Additionally, in our Report, we have asked directors and shareholders to consider how the effectiveness of general meetings could be improved.

OUTSIDE DIRECTORS

At the same time, in the United States the SEC is broadening the categories of resolutions which shareholders can bring forward. Thus moves to narrow the gap between owners and managers are common to reform proposals in both countries.

I wish to focus, however, on the role of boards in improving corporate governance, and especially on the part which independent outside directors can play in that process. Although we use the accepted British term "non-executive director" in our Report, I prefer the title "outside director". "Non-executive" is a negative description, it refers to what the directors are not, as opposed to what they

are, it suggests toothlessness and it is not wholly accurate, since circumstances may force them to act executively. "Outside director" is also in line with American usage.

Independent, outside directors feature prominently in our Committee's proposals, as they do in the practical and imaginative proposals being put forward in the United States by Martin Lipton and Jay Lorsch.* To an extent, the appointment of effective, independent directors is linked to increasing shareholder influence, as outside directors are well placed to judge where the balance should lie when there is tension between managerial and other interests. This emphasis on the role of independent, outside directors in the governance process, in both Britain and the United States, raises a number of interesting questions.

APPOINTMENT PROCESS

The opening question is where will such directors come from and how should they be appointed. The appointment process is an essential aspect of independence, because directors who owe, or who think they owe, their place on the board to the chairman or to the chief executive have already had their ability to take an independent stand whittled away. The erosion of independence through patronage is starkly documented in "Barbarians at the Gate".

In any case, the search for outside board members should start with the task and not with names. This forces chairmen and their fellow-directors to think about the kinds of experience and ability they are looking for to complement those of existing board members.

That in itself is a good start along the road to board effectiveness and means that if the search for appropriate candidates is properly carried out, there will be a number of names to choose from, so ensuring an element of competition in the selection process. This puts boards in the position of being able to pick the best candidates, not simply acceptable

* "A Modest Proposal to Improve Corporate Governance"

ones, and those so selected have the confidence of knowing that they have earned their place on merit.

AVAILABILITY

What about the supply of competent, independent directors, if reform proposals are going to demand more of them? There are certain factors working towards reducing their numbers. The job of a conscientious, outside director will become more onerous in the wake of our Committee's Report. The same is true in the United States where William T. Allen* said of the duties of outside directors in a recent speech:-

"The demands of the position, if properly understood, are inconsistent in my opinion, with service on an impressively long list of boards."

In addition, outside directors will probably become more liable to litigation, although this is as yet more of a threat in the United States than in Britain, and the definition of independence is likely to become more rigorous. This has prompted an American proposal for the formation of a cadre of professional outside directors, who would serve on perhaps six boards each, in order to increase the supply of competent directors and to strengthen their independence.*

My experience with PRO NED, a British organisation which assists chairmen to find suitable outside directors for their boards, suggests that there need be no shortage of good candidates. The post is seen as challenging and rewarding in its own right. There is, however, one proviso to my assertion and that is that chairmen are prepared to fish in a deeper pool than the traditional one of fellow main board members (preferably chief executives) of similarly sized companies. Again, an advantage of using an outside agency to search for candidates is that they will tap a wider potential market, including the divisional directors of large firms and those in voluntary and public service organisations.

* Chancellor, Delaware Court of Chancery, April 30 1992.
** Reinventing The Outside Director, Gilson & Kraakman, June 5, 1990.

INDEPENDENT DIRECTORS

This leads on to a more difficult question, which is how "independence" in this context should be defined. The straightforward definition, which our Committee used in its Report, is that outside directors are independent, if they are free of any business or financial connection with their company other than their fees or shareholdings.

Outside directors who have no such connections are in the strongest position to take the lead on those committees of the board, like the audit, remuneration and nomination committees, where potential conflicts of interest could arise. Takeover bids, management buy-outs, top-level succession and determining directors' pay are all examples of situations where managerial and company interests could diverge. The same can be true over the presentation of financial results. Resolving conflicting interests is inherent in the board's job and in doing so the independence of judgement of outside directors is invaluable in assisting the board as a whole to come to a decision.

Should, however, cross appointments debar a director from being considered independent? Martin Lipton and Jay Lorsch think so and have said,

"We would not view as independent an executive of another company on the board of which an executive of the company serves."

Or, to take another example, how high do fees have to become or how large the shareholding before independence is threatened? It is surely all a matter of degree and the approach of the New York Stock Exchange to the membership of audit committees seems to me to put the ultimate responsibility where it belongs.

"....an Audit Committee comprised solely of directors independent of management and free from any relationship

that, in the opinion of the Board of Directors, would interfere with the exercise of independent judgement as a committee member".

In the end, it has to be for the directors individually and collectively to determine who is in a position to exercise independent judgement. The test which they would apply in respect of a business relationship would be whether it was material. There is no reason to suppose, for example, that if the outside directors of a bank hold accounts with that bank, that this would affect their independence of judgement.

What is material, however, is an individual matter and cannot be judged by reference to a universal set of rules. Even when it comes to fees and shareholdings, what could be immaterial to one director could be material to another. We have, therefore, to work to broad guidelines, but the final responsibility for determining who, within those guidelines, is in a position to exercise independence of judgement rests with board members themselves.

However, those to whom the directors are accountable need to know on what basis the decision as to who is independent has been arrived at. Here we come back to the principle of disclosure. Directors should disclose their interests in full, particularly if they have an interest in an enterprise which is in some way dependent on the company of whose board they are a member. Provided that all such cross-linkages are brought out into the open, shareholders and others can check for themselves the definitions of independence which boards have used.

The question which follows is whether shareholders should insist on all outside directors being independent. I believe that this would be unnecessarily restrictive and would deprive boards of wise counsel. Bankers, for example, whose firms act for the company, or directors of connected businesses who thereby have a working knowledge of the industry from another angle, can be invaluable board members.

They will simply not take part in discussions on matters in which they could be said to have an interest. They cannot, however, be considered as independent directors when it comes to classifying directors for appointment to board committees.

COMMITTEES OF THE BOARD

These committees and especially the audit committee have a vital part to play in enabling outside directors to make an effective contribution to the boards on which they sit. By definition, outside directors lack the intimate knowledge of the business of the executive directors. They are, therefore, crucially dependent on the information provided by the company.

It is the chairman's responsibility to ensure that the flow of information is tailored to meet their needs and that they are put on as equal a footing as possible with their executive colleagues. The ability of an outside director to understand enough of a business solely from attendance at board meetings has to be limited. This is why boards which aim to get the best out of their outside directors invite them to visit company sites and to attend strategy conferences and the like.

The plus of board committees is that they give the outside directors a formal place in the company structure beyond the board. Membership of an audit committee, for example, provides outside directors with the opportunity to review their company's financial control systems and their risk assessment processes, as well as carrying out an essential function on behalf of their board. Thus board committees are an important way of enabling outside directors to be effective board members.

PROBLEMS ON THE BOARD

There may be times, however, when the independent directors either know or suspect that their board is failing in its

duty and they then have to decide how to act. They would normally raise their concerns at the board or with the chairman. But if the chairman or the rest of the board are themselves the problem, these approaches are unlikely to resolve the matter, leaving the independent directors either to resign or to act to enforce change.

The ISC in its publication," The Role and Duties of Directors" has this to say about such a situation:-

"... the non-executive directors should acknowledge a particular duty to monitor the performance of the board as a whole, and to report to the shareholders if they are not satisfied after reasonable efforts have been made by them to remedy the causes of their dissatisfaction."

An appeal to the shareholders over the heads of the chairman and of the board is a possible course of action, but it has constitutional implications to which I will return. The direct question which it raises is to whom within their ranks will the independent directors look for leadership in such a situation? A leader is likely to emerge in time when board problems become serious enough and independent directors have shown that they can act decisively on their own, as they appear to have done recently at General Motors. But are there ways of strengthening the hand of the independent directors to assist them to act firmly and expeditiously should serious problems arise?

Our Committee has proposed that if the chairman is an executive director, a senior outside director should be appointed to take the lead to maintain the balance between the outside and inside influences on the board. We point out that a number of companies have recognised that leadership role and that some have done so formally in their articles.

In the United States, Martin Lipton and Jay Lorsch have made a similar proposal, with the interesting rider that the post might be rotated annually or biannually between the

independent directors. The most straightforward way of ensuring that the independent directors have a convenor, if the chairman is an executive director, is to appoint one of their number as deputy chairman. I regard the deputy chairmanship as a useful and underused post in maintaining an appropriate balance of power on a board.

Another of the Committee's recommendations for strengthening the position of the outside members of a board is that they should be able to take independent professional advice, when necessary, at the company's expense. Responses to our draft Report have proposed that such a facility should be available to all board members.

CAN INDEPENDENCE AND UNITY BE COMBINED?

The discussion so far has concentrated on how the influence of the outside, and particularly the independent, members of a board can be enhanced. The outside directors are appointed to complement the executive directors by bringing an independent, objective judgement to bear on board decisions. This does not infer that executive directors are unable to be objective, but the outside directors do not stand as close to the business as the executive directors and are not involved in the management build-up to decisions in the same way. In both the UK and in the US, competent, outside directors, the majority of whom should be independent, are seen as the guardians of the shareholder and public interest on boards.

The increasing weight of responsibility which outside directors are being expected to carry raises a fundamental constitutional issue. Can the concept of the unitary board be reconciled with the increasing allocation of specific duties, particularly to independent directors? Taking the point one stage further, in the context of closer European unity, should British companies be at least considering a move towards a two-tier board structure, so separating the supervisory role of the board from its management role?

Many of the responses to our Committee's draft Report fear that our proposals could prove divisive and so might undermine the unitary nature of our present board system. To an extent this reflects our terms of reference which focus on the control and monitoring functions of the board, where independent directors have a leading role to play, and the Report thereby presents a one-sided picture of the board's overall task. It may also be that in the draft we have failed to make our backing for the unitary board sufficiently clear. These are matters of emphasis which can be addressed in the final report.

Nevertheless, the question of how far directors' duties can be differentiated without dividing a board is a real one. There could come a point when the emphasis on the separate roles of executive and independent directors could make the present compromise between the monitoring and management duties of the board unworkable. I do not believe that we are at that point and I do not see the part which the Committee proposes that outside directors should play in corporate governance as representing an ineluctable move towards a two-tier system.

What the Committee is proposing is a division of responsibilities between the members of a united board, not a division of the board. Just as executive directors will take the lead in matters where they are expert, so will the outside directors where it is independence of judgement which is being sought. The ultimate decisions, however, will be those of the board as a whole, to which all directors will have contributed and to which all will be committed.

I would contrast this allocation of responsibilities <u>within</u> a board to the ISC proposal that the outside directors as a separate group should, if necessary, appeal direct to the shareholders. In my view this would undermine the unitary nature of the board, let alone the authority of the chairman, because it would give the outside directors a different reporting line to the executive directors and one which led

beyond the board. The key point about our Committee's proposals is that they are directed to the way in which boards divide the work among themselves, in order to make the most of the individual capacities of board members.

What is undoubtedly true is that the greater the emphasis placed on the particular contribution, which the outside directors are expected to make within the board, the more demanding becomes the role of the chairman. This I would suggest is a sufficiently telling reason for separating the posts of chairman and chief executive. The responsibility for holding the board team together is the chairman's. It is for the chairman to ensure that each director contributes to the board's deliberations from their own point of view, but that the outcome is a collective board decision.

As to whether the way in which the role of the outside director is developing will nudge Britain towards two-tier boards, that is likely to remain an open question for some time to come. The two-tier model is only one among a number of board variants within the European Community, although it has the authority of the successful German economy behind it. In addition, the way in which boards are constituted and work in different countries reflect their economic and social backgrounds.

Convergence of board structures has to be seen in the context of convergence of the frameworks which support them and a greater harmonisation of economic and social conditions in what is likely to be an expanding European Community seems some way off. What would be helpful, however, would be a willingness by British companies to experiment with varieties of board structures, so that the evolution of board systems could be guided by practical experience.

CONCLUSION

In sum, the principles on which I suggested our Committee's recommendations were based all have a part to play in raising

board standards and in encouraging confidence in the country's system of corporate governance. The key to improving corporate governance lies within the boardroom. It is the ability of boards of directors to combine leadership with control and effectiveness with accountability that will primarily determine how well British companies meet society's expectations of them.

Adrian Cadbury
28/8/92.