

Committee on Financial Aspects of Corporate Governance

I was grateful to Committee members for their advice at last week's meeting and for their patience in dealing with a difficult agenda. I accept that our discussions will have a clearer focus, as soon as we can decide on the form which our draft report is likely to take. We were given the aim of producing a Code of Practice, but for the time being have adopted the more general objective of recommendations on best practice. The suggestion that we might follow the structure set out in Minute 7 was particularly helpful and could guide us as we go through the items on our agenda.

Whatever form our recommendations take, we will need to include proposals for putting them into effect, monitoring them and keeping them up to date. It will be for those who set us up, or the wider constituency involved through the members of the Committee, to decide what action to take on our findings.

Reflecting on our discussion of the paper on the functions of non-executive directors, there would seem to be advantages in basing our recommendations in this and other appropriate areas on broad principles. The reasons include the constraints of time, not overlapping with others in the field and avoiding being drawn into more and more detail (trying to define "non-executive directors" or "independent directors", for example). At the same time, we could usefully draw attention to the main sources of guidance to which those concerned could turn in interpreting our recommendations.

A statement of principles can be reasonably brief and it can be required to be followed in spirit, rather than evaded through the small print. It can also insist that substance rules over form. I recognise the concern that the outcome may sound platitudinous, but we should not, in my view, worry too much about this. First, if our principles were to be revolutionary they would be unlikely either to be sound or

enforceable. Second, it is making the principles stick which is important.

The problem of not saying anything new applies particularly in fields where generally accepted statements are already available, such as we found with the functions of non-executive directors. Here we cannot, as was pointed out at the meeting, support only those parts of the codes produced by others of which we approve, still less re-write them. We, therefore, have to put our recommendations into our own words, while drawing attention, where appropriate, to the more detailed guidance of others.

We do have to keep continually in mind that our remit is limited to the financial aspects of corporate governance. The conclusions which follow do not have a specifically financial focus, except in so far as they deal with remuneration. However, I think it is essential to start by establishing the Board framework within which such later items as audit committees and internal financial controls will have to fit.

On this basis, I would summarise our conclusions on non-executive directors as follows:-

- Every public company should be headed by an effective board, which combines executive knowledge of the business with the broader view of the company's activities provided by outside directors. It is the collective responsibility of the shareholders to ensure that the boards of their companies are properly constituted.

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- Non-executive directors are on boards to bring an independent judgement to bear on issues of strategy, performance, ^{remuneration,} key appointments and standards of conduct. They should be sufficient in number and calibre for their views to carry significant weight on the board.

- Within the board, non-executive directors have a particular responsibility to monitor the performance of the

board as a whole and that of the chief executive and to make the chairman aware of their views.

- The chairman is responsible for the working of the board, for its balance of membership and for ensuring that the non-executive directors are encouraged and enabled to play their full part in its activities.

- Given the importance and particular nature of the chairman's role, it should in principle be separated from that of the chief executive. Where the two roles are combined, it is particularly important that there should be a strong, independent element on the board.

- The essential quality which non-executive directors are in a position to bring to the board's judgements is that of independence. The majority of non-executive directors on a board should, therefore, be free of any business or financial connection with the company, apart from their directors' fees. These should be in line with their contribution to the company and should not include participation in share option or pension schemes.

- It follows that non-executive directors should be selected with the same impartiality and thoroughness as senior executives. Boards should appoint nominating committees, with responsibility for proposing to the shareholders any additions to the board and for ensuring that the shareholders have sufficient information about candidates for election to make an informed judgement on their suitability.

- Boards should also appoint compensation committees, consisting solely or mainly of non-executive directors to determine the remuneration of the executive directors in all its forms. Executive directors should play no part in determining their own compensation packages. The membership of the compensation committee should be included in the Directors' Report.

- It is the responsibility of the compensation committee to determine the appropriate level of remuneration for the executive directors, drawing on such outside advice as is necessary. Its chairman should be available to answer shareholders' questions on remuneration principles and practice at the AGM.

- The overriding principle in respect of remuneration is that of openness; shareholders are entitled to complete disclosure of all present benefits of directors and of any future commitments and of the way in which they have been arrived at.

This is simply a first attempt at stating some principles in relation to the role of non-executive directors. I have summarised what I thought were our conclusions, but you may not agree that I have done so correctly and I have made some minor additions for the sake of clarity. The wording certainly needs to be improved.

Four further issues arose at the meeting, the first of which was training. This could be covered by something along the lines of:-

- It is up to individual directors to instruct themselves as to their legal duties and their broader responsibilities and to keep themselves up to date in these matters. To this end, a comprehensive course is being developed for the directors of quoted companies, in addition to existing courses and works of reference.

The second was the contentious question of the rights of the directors to seek outside advice in the course of discharging their duties. I said that I would circulate PRO NED's opinion which was carefully worded after taking legal advice. It is contained in the appointment booklet which the Secretary is sending you. In essence, PRO NED's position is that a

non-executive director should have access to separate legal or financial advice, at the company's expense, subject to consulting in advance either the Chairman or another non-executive director. If the Committee agreed, we could add after the sixth indent above:-

- Non-executive directors should have the same right of access to information from company management as the other directors and should have the right to be reimbursed for any outside professional advice which is necessarily sought in the performance of their duties.

wording

Third, there was the point raised by the ISC proposal that the non-executive directors should be under a duty to report separately to the shareholders should the need arise. The constitutional importance of this innovation is that it would divide directors between those solely with duties to the board and those with duties to the body of shareholders outside the board. It would alter the role of the chairman, who is at present the accepted channel of communication between the board and the shareholders and it would require a means for the non-executive directors to co-ordinate their views and to convey them to the shareholders.

The majority of the Committee did not feel that such a major change was necessary in order to enable the non-executives to voice their dissatisfaction. This leaves us with the option of rehearsing the arguments for and against this proposal, or of leaving the matter on one side. We will need to have a section in the report dealing with the reasoning behind our conclusions and behind our choice of issues on which to make recommendations. Such a discussion section could, as was suggested at the meeting, draw attention to areas where further work was needed before effective recommendations could be made.

Finally, there was the suggestion that we should recommend a reduction in the point at which director's service contracts should become subject to shareholders' approval, from five

single report for which the whole ⁻⁵⁻ board is responsible - board should speak in the voice. J.C.

years to three. The majority appeared to support the proposal, but by then we were running out of time. I would be glad of your views on this matter, so that we can decide whether or not it should form part of our recommendations.

I would be grateful for your reaction to the framework proposed in this note and to the specific recommendations which I have outlined, either at our meeting on October 17th or before.

Adrian Cadbury

2/9/91.