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Enforcement Revisited/Boardroom Practices

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Finding Independent Directors: where and how?

The question of where and how to find independent directors for boards is not new and it is certainly not one that Asia faces alone. In this session I'd like to explain how in two very different environments innovative, modestly funded, and entrepreneurial initiatives generated a new pool of talent that companies and shareholders willingly use to strengthen boards.

Finding directors willing and more importantly able to fulfill their tasks on boards has never been simple. An early charter issued by the Bank of England in the 1600s set out the qualities that were sought in members suitable for appointment to the court of governors. The Old Lady, as is fondly known in London, was looking for Suitable Gentlemen with 'sufficient leisure' (that is, time to do the job well) and 'opportunity' in order to ensure they were suitably distant from the throng of daily affairs (in order to be able to contemplate the best interests of the Bank of England) and honourable (highlighting from the start that moral sense and integrity were as vital as commercial acumen and devotion to the task)¹. In other words, at this early stage it seemed important to define the qualities sought in a director.

In 17th century London no doubt a number of suitable gentlemen could be found during a pleasant afternoon in the coffee houses, or evening smoking session at a pub. Potential candidates would be known by reputation, and would be expected to be well connected. Your good name was your marquee. However, to be considered eligible for an invitation to become a director it was wise to ensure you were a Gentleman and a Protestant.

Three hundred years later the Bank of England was at the centre of the first initiative in the UK to go beyond personal contacts and informal recommendations in order to build a cadre of non-executive directors. The spur was the secondary banking crisis in the 1970s in which the UK's central bank recognized that weak boards had made a fatal contribution to financial collapse. It was plan that the Bank's own role of supervising the financial system was unequal to the task of ensuring stability unless there were competent and objective directors overseeing the executive management. Independent and competent directors were better placed to ensure risks were properly managed and hence to contribute not only to the bank's own security and prosperity, but the robustness of the banking system overall. The Bank of England understood full well that there was a public interest at stake, as when bank's collapsed the consequences were profound for depositors and contagion could quickly threaten a whole economy. That lesson was learned again during the Asia crisis which showed how weak governance in the banking sector could exacerbate both domestic and international financial panic. The need was clear. The solution posed some daunting challenges.

The question facing the Bank of England was the same one being considered today at this meeting of the Asia Roundtable. Regardless of the academic or professional studies and evidence, it seems an intuitive observation that boards of directors will function better if they are staffed by individuals who are able to provide independent oversight. It was not at all obvious where they would come from and how they would be found. The challenge was not

¹ See the full text in 'Fair Shares: the future of shareholder power and responsibility' Charkham and Simpson, Oxford University Press, 1999

to find a handful or so gentlemen of good character within a muddy carriage ride across London, but hundreds of potential directors to join boards around the country.

The Bank joined together with a number of other institutions concerned to strengthen boards of directors: the London Stock Exchange, the British Bankers Association, and a number of institutional investor trade bodies, among them. They decided to jointly sponsor a new institution which would find, mentor and advise non-executive directors.² The simple but bold mission was to promote the non-executive director to British companies seeking to strengthen boards. The new body was given a modish title: PRO NED, an almost acronym. Note that this plan was not backed by regulation, private sector investment, or even a code of best practice. It was an exercise in practical DIY – ‘do it yourself’.

The Bank of England for its part provided two key people to get the new initiative off the ground: Jonathan Charkham, then adviser to the Governor who was seconded as the Director of PRO NED; and one of their own Directors, Sir Adrian Cadbury, who would serve as Chairman. The two formed an enduring partnership which has a profound impact upon governance in the UK and beyond.

PRO NED had made a promising start in terms of name and reputation, but it still did not solve the problem of where to find promising candidates to fulfill the role of being independent directors. The world of professional head hunting barely existed. Suggestions for board appointments were more likely made on the golf course than via any formal process. Nominating committees were not heard of. Jonathan Charkham decided that direct action was the best approach and arranged personal meetings with the Chairmen of some 30 leading companies. This was not simply to talk about the dilemma, but to ask for some practical help. The meeting would finish with a straightforward question: would you give me your three best people? In most cases, the answer was “if they are willing, then, yes”. Generally, they were indeed willing and PRO NED rapidly built up a file of several hundred individuals with senior board and executive experience, available to serve as non-executive directors on the boards of other companies.

The Charkham charm offensive in the City’s was only the start. Having identified a cadre of senior people willing and able to serve, the next issue was to provide some practical and professional advice as to what they would do once they arrived on the board of a company, especially one where they were not employed as an executive. This was in an environment where typically the non-executive director would be appointed for their connections with government or other business (former politicians, military or their spouses were not uncommon) but the challenge now posed was how to ensure this new class of independent director could be effective in promoting enterprise and ensuring accountability. Likewise, as the companies decided to bring in some fresh talent they in turn needed some help in working out how to ensure the new board member was well briefed and understood their role. PRO NED began the process of developing advisory notes on good practice in the boardroom, covering a wide range of issues, from the useful content in the letter of appointment, to the formation, purpose and workings of board committees (on audit and nomination for example) where the independent directors would really begin to make a contribution. The early booklets from PRO NED addressed these issues in a clearly written and short form drawing upon the experience of its supporters, both client companies and

² See references in the first edition of *Keeping Good Company*, by Jonathan Charkham, 1990, Oxford University Press, other details from conversations with the author

potential candidates from the board. Overseas examples were also drawn upon copiously, notably the US 1978 listing requirements on the role of the audit committee).

PRO NED became a success. It quickly brought together a pool of talented and willing individuals, offered a service which could help companies identify the skills and experience they were looking for and match with potential candidates, followed up with some real life wit and wisdom on the subject of what to do in the boardroom to ensure that the non-executives really could fulfill their potential. The PRO NED years contributed important thinking and insight into the recommendations made by the Committee on the Financial Aspects of Corporate Governance, (known as the Cadbury committee) in the first code of best practice issued some years later. It also provided a handsome repayment to its founders who had covered the modest start-up costs. As the market came to understand and value the importance of the role of independent directors, the PRO NED founders decided to sell their stakes to an international head hunting firm, Egon Zehnder, with the view that their role as a catalyst was complete and it was time for the private sector to take over. The PRO NED story shows that progress can be made with modest means, with the right reputational backing and market support.

Since PRO NED was founded the debate on the role of non-executive directors has both deepened and broadened. In the most recent enquiry into the quality of the British boardroom, Sir Derek Higgs, commented dolefully that weakness stemmed from being too “male, pale and stale” adding wryly that as he fitted all three categories he felt qualified to comment. The Higgs Report prompted a new round of thinking and one which reflects another dimension to the question of recruiting independent directors: independence defined as what you are not, through business or commercial relationships, as to independence defined as what you could be, namely one who was willing and able to challenge, and be objective in the face of conflicts of interest and professional loyalties. Clearly independent directors still have great trouble with this. The inability to say ‘no’ on soaring pay is just one example in the US.

It was long recognized that part of the problem in the UK was its cosy elite – dubbed ‘the old boys’ network’ which bound together the leaders of business, civil service, government and military through relationships built over years through private schools, Oxbridge, shared gentlemen’s clubs and even regiments. The result was a financial network in the City in which ‘my word is my bond’ could function effectively as a social contract. There are advantages to such trust based relationships, but the role of the independent director requires more. Depth of understanding, close relationships and business acumen are all vital to non-executive directors playing their role. But without the willingness to challenge conventional wisdom, interrogate assumptions, question propositions, and to be able to just say no, the non-executive director cannot fulfill their role.

Being able to offer a constructive but skeptical stance in the boardroom is partly a question of character. It also is a question of having a range of experience upon which to draw. Too often the reason for a stale and one-dimensional debate is that the group around the table has a shared view, a shared experience and perhaps a shared fear of rocking the boat. It’s just not done. This thinking around the Higgs report raised a new idea: could boardroom diversity be a catalyst for independent thinking in the boardroom? Some research suggests there is evidence from France that boardrooms where the directors share the same social and educational background a failing CEO is less likely to be removed. Perhaps the

inability to break the ties that bind could even contribute thereby to corporate failure or underperformance.³

Others have not waited for the results of academic study but have decided to find ways to build a new pool of talent which is diverse. Social stratification of all sorts has meant in most economies that elites do not reflect their wider society, by gender, ethnicity or even religious background. The board room is no different. The result is that when boards have sought to recruit independent directors who have the necessary experience and qualifications to fulfil the role, they will be fishing from the same pool, just as PRO NED did, recruiting from other boardrooms of peer companies. The result is pressure upon the time of the available individuals who cannot meet demand in other companies, and also the concern about ‘group think’.

Governments have in some cases begun to approach this issue with social and economic concerns in mind. South Africa introduced black empowerment legislation to accelerate the exit from apartheid by requiring a proportion of equity and boardroom representation for what had been the excluded black majority; Norway and France have put forward proposals to require boardrooms to reflect gender balance. Currently in Europe where the average board size of 15, rarely is there more than 1 or 2 female directors, if at all.⁴ In the United States the situation is not so different. On the boards of Fortune 1000 companies, women make up less than 14% of the directors, and directors from ethnic minorities (who comprise 29% of the US population) held less than 7% of seats.⁵

A group of successful chief executives and directors decided it was time to broaden the pool of talent available to companies, aware that the same question was still posing a challenge: where and how? The Directors Council was formed 8 years ago to provide an answer. Michele Hooper, the founding director, has over twenty years board experience, including chairing the audit committee at companies such as Dayton Hudson, Target and sitting as a non-executive director Astra Zeneca in the UK, Warner Music Group and Seagram Company. Her view was that her networks through the African American and wider ethnic minority business community were simply not being tapped into.

With seven other business leaders who were women from ethnic minorities she formed the ‘200 Group’ with the idea that between them they probably knew this number of chief executives and board members who could potentially be available to serve as independent directors on other companies looking to strengthen their boards. Within a short while the name was changed, as they swiftly headed past the 200 target, as those who joined brought with them new networks, new names, across the United States. The driving force is a business need as they argue that “to recruit new independent directors, corporate boards will need to look beyond conventional sources”. They point out that the number of available and qualified candidates will need to expand simply to fulfill the growing demands upon independent directors, not least under Sarbanes-Oxley legislation. In these circumstances companies cannot afford to exclude more than half the population is their hunt for the best candidates. Better still, they may bring in a diversity of experience and perspective which

³ Social Networks in the Boardroom: working paper, Francis Kramarz (CREST-INSEE, CEPR and IZA Bonn) Davis Thesmar (HEC School of Management, Paris and CEPR) IZA discussing paper number 1940, January 2006, with thanks to Jonathan Koppell, Yale SOM for pointing this out

⁴ ‘Women on European boards: Scandinavia extends its lead’, results of the EuropeanPWN BoardWomen Monitor 2006-09-08

⁵ Figures quoted from the Directors Council, www.directorscouncil.com

catalyses independent thinking in the boardroom. The project is self-financing, expanding, and now serving some of the largest companies, like Time-Warner and Caterpillar. They have also drawn praise from their head-hunter rivals, such as Spencer-Stuart, who realise that The Directors' Council is tapping into sources which the recruitment industry has not been well connected to, and that all sides benefit from the new talent made accessible to the boardroom.

Clearly answering the questions of 'where' and 'how' to find independent directors is only the start. There are other challenges which different sessions in this Roundtable will examine, such as how do independent directors have influence unless they win the support of the controlling shareholder? How do independent directors frame their duties and actions in respect of minority shareholders? Can they contribute to better decision making when boards are facing conflicts? Those are important questions which require real work and attention. The shared view at this stage is that the quality of the outcome when boards face these dilemmas be directly affected by the calibre of those responsible. Independence is vital to that calibre.

What is heartening is that a wide range of markets are now actively engaged in building the networks, professional bodies and training facilities that focus not just on what the independent director is not (ie a non-executive) but what the independent director could and should be. There is also a growing interest in the dynamics of the boardroom, going beyond a compliance imperative. The work of [idea.net](#) is a leading example of this work, not just in Asia, but in other regions where it has been working alongside many other groups who are beginning to collaborate and share experience on how to fulfill the potential of the independent director.⁶ Where and how may be the first questions, and they are vital to answer, but they simply then start the board on a journey. Finding and appointing the independent directors is a vital first step, but only that.

(not for quotation - check against delivery)

⁶ As a source of international groups working in the field, and step-by-step advice on how to develop a director professionalism programme see the Global Corporate Governance Forum toolki on the same at www.gcgf.org