GOVERNANCE
LAB

THE GROWING IMPORTANCE OF THE ROLE OF NON-EXECUTIVE AND SUPERVISORY DIRECTORS IN CORPORATE GOVERNANCE[1]

Joana Vitorino Mendes

LLM, Catolica Global School of Law

Working Paper No.07/2015

June 2015

[1] This paper was written as part of the Comparative Corporate Law seminar of the LL.M. Law in a European and Global Context, taught by Professor Paulo Câmara, at Católica Global School of Law, on 30 April 2014.

Keywords: Corporate Governance, Non-executive Directors, Supervisory Directors, 1992 UK Cadbury Report, 2002 US Sarbanes-Oxley Act, EU Corporate Law, OECD Principles on Corporate Governance, Comparative Corporate Law.

THE GROWING IMPORTANCE OF THE ROLE OF NON-EXECUTIVE AND SUPERVISORY DIRECTORS IN CORPORATE GOVERNANCE

Joana Vitorino Mendes
joanavmendes@gmail.com

Abstract

Executive Summary

The monitoring or controlling dimension of a company was essentially conceived to address the conflicts which may arise from the relationship between corporate managers and shareholders or between majority and minority shareholders (*agency* problems). In a one-tier corporate model this function is traditionally assigned to non-executive directors (NED's), while under a two-tier model this task is usually given to supervisory directors. Indeed, in 1992, the UK Cadbury report already called attention to the importance of NED's for the maintenance of good standards of corporate governance.

The new millennium however brought major challenges to the role, within the companies, of NED's and supervisory directors that eventually gained great importance within the modern corporate governance practices. The financial corporate scandals in big companies, among others, as Enron, WorldCom or Parmalat, and the 2008 financial crisis, led both national and international corporate governance schemes to take NED's and supervisory directors as efficient – and necessary – key players for promoting business prosperity.

Within this framework, the present paper addresses the growing importance of NED's and supervisory directors in corporate governance, particularly when seen as responses to the financial corporate collapses and the crisis. In particular, by briefly describing some national and international experiences and approaches in this regard.

TABLE OF CONTENTS

1. CORPORATE GOVERNANCE: RESPONSE TO THE AGENCY PROBLEM

Corporate law is structured according to the common problems of corporations. In this regard, the principal-agent *agency problem* has been suggested as the main driver of corporate law.[2] Corporate traditional actors' interests, *i.e.* managers and shareholders, enter into conflict when directors' delegated management powers do not meet the interests of who they act on behalf of – the shareholders, owning the corporations' money. This natural mismatch between the corporation's management and ownership may lead to agents' inefficient performances, disloyal behaviours or rent extractions, and private benefits from their management powers. A second agency problem usually arises from the majority and minority shareholders especially in controlling shareholders' structures.[3]

Scrutiny of corporations' directors is then a solution to these recurrent problems.[4] The famous 1992 Cadbury's definition on corporate governance, the "system by which companies are directed and controlled"[5], already acknowledged this control dimension. But shareholders' scrutiny – both over corporations' managers and on their fellow shareholders – may not be efficient enough, due to their frequent lack of corporate management's knowledge and training. Thus, other control actors, either internal or external, are required to intervene.

The present analysis only focuses on the internal balance between corporations' board and shareholders, and disregards – despite their growing importance – the role of external monitoring stakeholders, such as auditors.

2. THE BOARD: THE DENIAL OF THE ONE-SIZE-FITS-ALL APROACH

Traditionally, the board has the dual function of management and monitoring. This dual role is usually organized under either a one-tier or a two-tier model. In a one-tier model, the board's functions of management and monitoring are assigned, according to a

[2] See, *e.g.,* Armour, Hansmann and Kraakman (2009), or Hopt (2011) 4.
[3] A third conflict may also be mentioned, between shareholders and other stakeholders, such as bondholders, labor, or creditors: Hopt (2011) 4-5.
[4] Nell Minow (2003): "Boards of directors are like subatomic particles – they behave differently when they are being observed".
[5] Cadbury (1992) 2.5.

functional distinction, respectively to executive and NED's, within the same board.[6] Under a two-tier model, management and control are easily distinguishable, with the creation of a separate supervisory board,[7] with supervisory directors. While one-tier models may facilitate a better flow of information in a united board, large corporations may prefer to separate management and control.[8] The debate on the use of a model over another has been, however, progressively disregarded both nationally and internationally.[9] The choice for one system depends on economic, societal and cultural conditions,[10] rather than on box-ticking, and "varies according to business sector, size of the corporation, tradition (…)"[11]: both systems may deliver adequate corporate governance solutions.

Thus, the present analysis covers both the corporations' monitoring figures of the NED's and the supervisory directors, as it privileges the growing importance of the role of internal control within corporate governance whatever its board's structure or model. In fact, the worldwide reforms on board models and internal controls have been given to independent corporations' actors, under the same principles, and regardless of specific denominations.[12]

3. THE MONITORING BOARD: ROLE AND FEATURES OF NON-EXECUTIVE AND SUPERVISORY DIRECTORS

After the 1980's businesses' failures and concerns over accounting, financial reporting, and confidence in external directors,[13] a 1992 Report of the English Committee on the Financial Aspects of Corporate Governance, known as the Cadbury report, drew special attention to the role of NED's – in the context of the one-tier UK model – within the chapter of board's effectiveness, namely on its control function. Indeed, "[t]he Committee believe[d] that the calibre of the non-executive members of the board is of special importance in setting and maintaining standards of corporate governance".[14] NED's were considered to "bring broader view to the company's activities",[15] on issues of strategy,

[6] Hopt and Leyens (2004) 11: "The one-tier board model (...) entrusts both management and control to the (...) board of directors".
[7] Hopt (2011) 21.
[8] Ibid. 22-23.
[9] See, *e.g.*, OECD (2004) 13, or Hopt (2011) 22. "[t]here is no stringent theoretical – let alone empirical – proof that one of the two systems is better than the other": Hopt (2011) 22.
[10] Hopt (2011) 8.
[11] Ibid. 21.
[12] Hopt and Leyens (2004) 19.
[13] Dixon, Milton, and Woodhead (2005) 1-2.
[14] Cadbury (1992). 4.10.
[15] Ibid. 4.1.

performance, and resources.[16] Their inherent independence, both from executive responsibility and from shareholders' interests, was also seen as particularly important: to review the performance of the executive directors, and to solve potential conflicts of interests.[17] The ultimate proof of the NED's importance is the recommendation of a minimum of three NED's on all boards, in which two should be independent.[18] In order to guarantee an effective role of these actors, within the corporate governance, the report also established some criteria for the NED's independence,[19] remuneration,[20] access to information, appointment, terms, and capabilities.[21]

Indeed, codes of practices, such as the early Cadbury report, have given a major role to the NED's role and features,[22] in the form of soft law. While the initial UK code was being continuously updated – the UK 1998 Hampel report, for example, confirmed that "there is no single formula, (…) and is dangerous to encourage the belief that rules and regulations about structure will deliver success",[23] and emphasized a third function, related to the NED's "contribution to the development of the company's strategy"[24] –, other worldwide governance codes called for NED's greater intervention on an effective monitoring.

"Consistent with the corporate governance codes, the academic research on the role of NED's focuses on three main roles".[25] The NED's monitoring function,[26] their conflict of interests' solving capacity, and their greater involvement within the corporations' strategy, were agreed to bring "a breadth of vision, experience, environmental scanning and being available as a sounding board".[27] Some scholars, however, criticized the over-emphasis on the role of the monitoring independent actors

---

[16] Ibid. 4.11.
[17] Ibid. 4.4.-4.6.
[18] Ibid. 4.11.
[19] "[I]ndependent of the company. (...) [and] independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement": ibid. 4.12.
[20] "[B]alance (...) between recognising the value of the contribution (...) and not undermining their Independence": ibid. 4.13.
[21] Ibid. 4.14.-4.17.
[22] Recommendations are usually established for listed corporations, but the present analysis addresses them as general corporate governance's guidelines.
[23] "Business cannot be commanded. People, teamwork, leadership, enterprise, experience and skills are what really produce prosperity": Hampel (1998) 1.2.
[24] Ibid. 3.8.
[25] Dixon, Milton, and Woodhead (2005) 3.
[26] Ibid. 3.
[27] Ibid. 3-5.

within the corporate governance, mostly based on the NED's lack of management information and strategy.[28]

4. The Growing Importance of the Role of NED's and Supervisory Directors in Corporate Governance: Response to the Scandals and the Financial Crisis

Despite different scholars' views on the specific content of the role that NED's or supervisory directors should play, there is no escaping from the empirical data revealing the growing importance of these actors in the corporations' structures.

In 2013, the top 30 companies presented, in a median number of 13 directors, a medium number of 10 NED's within the board; in FTSE 100, 7 NED's in a medium of 11 directors, against only 6 in 2002.[29] Taking the example of the multinational corporation Deloitte, its 2013 survey of board structure showed that for every executive position, there were 2.5 non-executive NED's positions in a FTSE 100 company.[30] As to the percentage of NED's in other separate committees, one may for instance look into the number of NED's in risk committees: in 2008, 14 of the biggest international banks had 100% of NED's percentage within their risk committees.[31] Reports also show that NED's are now more able to contribute to a corporate strategy, with higher experience levels than before,[32] which enables an improvement in companies boards' effectiveness.

The growing recognition of the importance of the role of NED's and supervisory directors within corporate governance is the most clear-cut example of how corporate structure responds to real life problems. The new millennium witnessed huge corporate collapses: the Enron and the WorldCom scandals in the US, or the Parmalat collapse in Italy, were some of the impetus to rectify governance weaknesses, and represented a "defining moment in the contemporary corporate governance debate".[33] The 1992 Cadbury's idea that an "economy depends on the drive and efficiency of its companies" revived and, indeed, corporate governance codes and reports, both nationally and internationally, deepened previous understandings on corporate structures to avoid new financial scandals. Counting on the NED's role, while improving their competence and

[28] Ibid.
[29] Higgs (2003) 18.
[30] Deloitte (2013) 5.
[31] *E.g.* Barclays, BNP Paribas, Deutsche Bank, … :Kirkpatrick (2009) 21.
[32] Thornton (2009).
[33] Hill, 2.

efficiency, was considered to promote business prosperity, with policy makers calling for strengthening the role of internal corporate monitoring: "[t]he idea of the independent director has become the new 'Holy Grail' under the reforms".[34]

In 2002, the UK government commissioned Higgs to report on the role and effectiveness of NED's.[35] The report indeed acknowledged the "recent corporate failures".[36] With regard to the role of NED's in particular, considered to "have a crucial part to play"[37] – again, within the UK traditional unitary board –, the Higgs report suggested that at least half of the board's members should be independent NED's[38] – going beyond the Cadbury's rule –, and establishing specific criteria for the independence requirement.[39] In addition to the three traditional roles of executive control, conflicts of interests' resolution, and strategy development, the Higgs report especially instructed NED's to check the accuracy of financial information and the robustness of financial controls and risk management. NED's role also began to be seen as an added value within other committees' composition, such as on executive directors' nomination,[40] executive directors' remuneration, and auditing the company's performance,[41] in which independent NED's should constitute the majority. Therefore, "expectations of non-executive directors have risen as increased business complexity has made it more difficult for individual shareholders".[42] Indeed, the current 2012 UK Corporate Governance Code continues in line with the 2002 scandals' responses with regard to the NED's role in corporate governance, tracing explicit governance responsibilities and conditions for effectiveness.[43]

In the same year of 2002, Brussels released a report on a Modern Regulatory Framework for Company Law in Europe in which, in a direct reaction to scandals like the Enron case, called for an active role of NED's and supervisory directors, irrespectively of the board's model, thus extending the original mandate of the working group:[44] fact that in itself clearly demonstrates the growing importance of the role of NED's for a good corporate governance. It also underlined the particular significant role of NED's on

---

[34] Hill, 19.
[35] Higgs (2003).
[36] Ibid. 1.2.-1.3.
[37] Ibid. 1.1.
[38] Ibid. 9.5.
[39] *E.g.,* not an employee within the last five years, no material business relationship with the company within the last three years, no close family ties with directors, senior employees or company advisers, or not served on the board for more than ten years: ibid. 9.10.
[40] Ibid. 10.9.
[41] Ibid. 13.2.
[42] Ibid. 1.6.
[43] "[A]ppropriate balance of skills, experience, independence and knowledge of the company (...)": FRC (2012).
[44] Winter (2002) 43.

nomination and remuneration of directors and audit of the accounting of the company's performance.[45] The 2002 report's recommendations were then incorporated into the 2005 EU Commission Recommendation on the role of NED's or supervisory directors,[46] confirming the MS' trend to recognize a significant role to NED's within the board and separate sub-committees, such as on the remuneration committees.[47]

In contrast to the European approach, in which UK took charge, the US adopted a legislative approach with regard to corporate governance,[48] and to monitoring in particular, when it came to respond to its national financial scandals. The 2002 US Sarbanes-Oxley Act imposed an independence requirement on the members of the audit committee,[49] as a committee of the board, while considered as unlawful to take any action to influence or mislead any independent actor engaged in the performance of an audit of the financial statements.[50] Thus, the US SOA also relied on an internal control structure for monitoring financial reports, and to avoid previous financial scandals. It also required the compensation and the nominating committee to be entirely composed of independent directors.[51]

The severe economic conditions that we face today, especially after the 2008 financial crisis that left the financial system paralyzed, with low levels of stability, confidence and economic growth, also called for a corporate governance intervention, especially through a voluntary approach of non-binding standards. Once again, corporations' good practices were given a special role, this time for the prosperity and development of financial markets.[52] In particular, the role of supervisory actors within corporate governance was, again, deemed essential, both nationally and internationally: as an example, the 2010 OECD report on corporate governance and financial crisis confirmed the 2004 OECD Principles of Corporate Governance – where objective and independent NED's were already given an express monitoring function both within remuneration and nomination committees, and within the board, where they should be in a sufficient number to give independent judgments and solve potential conflicts of interests[53] –

---

[45] Winter (2002) 8.
[46] Commission, 2005/162/EC.
[47] Câmara (2012).
[48] Armour, Hansmann, Kraakman (2009) 17.
[49] "[T]o be considered to be independent (...) may not (...) accept any consulting, advisory, or other compensatory fee from the issuer, or be an affiliated person of the issuer or any subsidiary thereof": SOA Sec. 301 (3) (B).
[50] Ibid. Sec. 303 (a).
[51] Hill, 19.
[52] Corporate governance is indeed seen as a strategic response to the financial crisis, under the OECD (2009) 10.
[53] OECD (2004) 24, 58-66.

focusing on their implementation, and recognizing the NED's role that corporations can benefit from, given their capacities, independence and objectivity.[54] In a European level, the European Commission launched a Green Paper on corporate governance, in 2011, where it reiterated the corporate governance's role for economic growth and a stronger international financial system, and the role of NED's participation on companies' boards.[55]

The recent 2012 Portuguese Corporate Governance Code is another example of a voluntary adherence code on companies' practices towards good corporate governance. It clearly rejects the *one size fits all* model, "delegating to the company the task to create and develop the most suitable regime to its own specificities",[56] defining both the terms of NED's[57] and the supervisory board[58] for the purposed of the code, and referring both to NED's and "members of the supervisory board" when it comes to recommend on supervision and auditing. In this regard, the 2012 Portuguese code follows the international pattern's response to the financial scandals and 2008 crisis when recognizing a growing role of – independent – monitoring actors, recommending an appropriate number to ensure the effectiveness of their role within the corporation's board.[59]

Also scholars have been recognizing NED's role as adding "value to the management of an organization bringing experience to provide and advice and independence to make informed challenges",[60] as well as being of growing importance for a qualified board monitoring in the corporate governance arrangement, as a *lesson* from the financial scandals and crisis.[61]

5. FINAL CRITICISM

The need to control corporations' conflicts of interests is not new. However, policy makers are now more aware of the contribution of good corporate governance's practices for a healthy company, as well as for a stable financial market, investment's confidence and economic growth. Similarly, the corporate governance's idea is today under the

[54] OECD (2010) 19-22.
[55] COM (2011) 164 final.
[56] Portuguese CGC (2012) Preamble.
[57] "[M]embers of the board of directors to whom management powers have not been delegated": ibid. Glossary B).
[58] "(...) [T]he audit board, in respect of the companies adopting the monist model; the auditing committee, in respect of the companies adopting the Anglo-Saxon model; (...)": ibid. Glossary E).
[59] Ibid. Chapter IV, Principles and Recommendations.
[60] Chartered Management Institute (2002) 7.
[61] *E.g.* Kirkpatrick (2009) 2.

public's scrutiny. Some go even further and argue that the financial crisis can be, to an important extent, attributed to failures and weaknesses in corporate governance arrangements.[62]

Worldwide corporate governance codes and standards uniformly show that internal monitoring actors, either NED's or supervisory directors, play an important role in this regard. Their role has increased particularly after the financial scandals and the crisis of the new millennium. While NED's face an increasing expectation on their role, some argue that this increasing reliance on NED's may be a panacea: a balance between NED's and management directors will be always needed, and the increasing call for the NED's role in corporate governance has its limits. Moreover, empirical studies still show difficulty in showing a positive correlation between independent boards and a good corporate performance.

[62] Ibid. 2.

6. BIBLIOGRAPHY

- ARMOUR, John, HANSMANN, Henry, and KRAAKMAN, Reinier, "Agency Problems, Legal Strategies and Enforcement" (2009) ECGI Working Paper N.º 135/2009
- HOPT, Klaus J., "Comparative Corporate Governance: The State of the Art and International Regulation" (2011) ECGI Working Paper N.º 170/2011
- HOPT, Klaus J., and LEYENS, Patrick C., "Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy" (2004) Law Working Paper N.º 18/2004
- OECD, "OECD Principles of Corporate Governance" (2004)
- CADBURY, Adrian, "Report of the Committee on the Financial Aspects of Corporate Governance" (1992)
- DIXON, Rob, MILTON, Keith, and WOODHEAD, Anne, "An investigation into the role, effectiveness and future of non-executive directors" (2005) Journal of General Management Vol. 31 No. 1
- HAMPEL, Ronnie, "Report of the Committee on Corporate Governance" (1998)
- HILL, Jennifer G, "Regulatory Responses to Global Corporate Scandals", Law and Economics Vanderbilt University, Research Paper N.º 06-04
- HIGGS, Derek, "Review of the role and effectiveness of non-executive directors" (2003); Sarbanes-Oxley Act (2002)
- Corporate Governance Code of Portugal (2012) Instituto Português de Corporate Governance
- OECD, "OECD Strategic Response to the Financial and Economic Crisis: Contributions to the Global Effort" (2009)
- OECD, "OECD Principles of Corporate Governance" (2004)
- OECD, "Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles" (2010) Directorate for Financial and Enterprise Affairs OECD Steering Group on Corporate Governance
- KIRKPATRICK, Grant, "The Corporate Governance Lessons from the Financial Crisis" (2009) Financial Market Trends, ISSN 1995-2864
- Deloitte, "At the helm: Board Structure and non-executive directors' fees. Incorporating responses from our 2013 survey of board structure and processes" (2013)

- Chartered Management Institute, "Review of the Role and Effectiveness of Non-Executive Directors" (2002)
- Financial Reporting Council, "The UK Corporate Governance Code" (2012)
- The High Level Group of Company Law Experts, in which, WINTER, Jaap (Chairman), "Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe" (2002)
- CÂMARA, Paulo, "The Governance Role of the Remuneration Committee" (2012) Governance Lab Working Paper No. 01/2012
- THORNTON, Grant, "Are they experienced? A review of FTSE 350 non-executive director experience" (2009) For the UK Financial Reporting Council