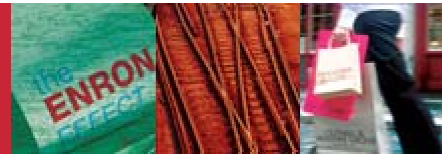
Risk&Regulation



Treading the Boards: The Systemic Risks of Directors' Interdependence

Yuval Millo, Will Jennings and Robert Wearing discuss how competing notions of independence, and the interlocking relationships of non-executive directors, may undermine their role as risk regulators.

In the post-Enron era, increasing regulatory attention has been directed towards non-executive directors (NEDs) and their role in corporate governance. In the United Kingdom, much of this attention is premised upon a belief that non-executive directors perform an important regulatory function in corporate governance. In response to a succession of corporate transgressions, failures and crises, a number of critical regulatory texts – the Cadbury Report of 1992, the Greenbury Report of 1995, the Hampel Report of 1998, and the Combined Code of 2003 – have increasingly emphasised the importance of the appointment of independent non-executive directors for transparent and efficient corporate governance.

Non-executive directors are intended to prevent a concentration of power with the chief executive officer and/or senior executive directors of the firm. To act as an effective counterweight to the executive membership of a board, non-executive directors are presumed to be independent from the firm.

Yet despite the crucial importance attributed to non-executive directors' independence, the formal regulatory definition of that independence is deficient, injudicious and is, itself, a source risk to the governance of firms and – through a systemic effect – the economy.

What are the problems inherent to the present regime of regulatory functions of boards of directors?

The evolution of regulatory definitions of the independence of NEDs reveals the emergence and crystallisation of two related concepts: the 'negative bilateral concept', and the 'negative probabilistic concept'. The negative bilateral concept assigns independent status to a director according to his/her lack of connections with a specific firm whereas the negative probabilistic concept assigns independent status to a director according to the lack of connections with specific categories and/or groups in the general population. These concepts dominate the contemporary regulatory debate about non-executive directors in Britain, but entail problematic characteristics that introduce systemic risk to corporate governance. First, the concepts do not define positively what constitutes 'independence' but instead provide only a by-default, deducible definition. Consequently, regulators cannot assess the interdependence of firms or the extent to which the interlocking connections might impact upon corporate decision-making. Second, the recruitment of non-executive directors becomes a utility-maximisation exercise. This introduces the possibility of gaming – where firms use appointments to subvert or circumvent regulatory standards.

How did this state of affairs arise?

The negative bilateral concept

The Cadbury Report, published in 1992, was the first attempt to focus on non-executive directors as an important mechanism for improving governance in UK quoted companies. The preface to the report of the Cadbury Committee referred to 'the continuing concern about standards of financial reporting and accountability, heightened by BCCI, Maxwell and the controversy over directors' pay'. Cadbury recommended that quoted company boards should each have at least three non-executive directors, a majority of them independent. Independence was defined as follows:

'[A]part from their directors' fees and shareholdings, they should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.'

Cadbury signifies the beginning of the bilateral negative definition for non-executive directors' independence: the less connections there are between the director and the firm, the more independent the director is deemed to be.

Three years after the Cadbury report, the Greenbury Committee was formed following widespread public concern over what were seen as excessive amounts of remuneration paid to directors of quoted companies and newly privatized companies. Greenbury recommended that the remuneration committee should consist exclusively of non-executive directors. These non-executive directors should have no personal financial interest, other than as shareholders, in the committee's decisions. Also, there should be 'no cross-directorships with the Executive Directors which could be thought to offer scope for mutual agreements to bid up each others' remuneration'.

Also in 1995, the Hampel Committee published a report in which it reviewed the implementation of the findings of the Cadbury and Greenbury Committees. Hampel recommended that 'boards should disclose in the annual report which of the directors are considered to be independent and be prepared to justify their view if challenged'. These recommendations were then included in The Combined Code, which was published by the London Stock Exchange in 1998. The recommendation to disclose the independence status of the directors and the backing of that recommendation by the London Stock Exchange signified a further strengthening of the bilateral concept: the corporate discourse that interprets the board's independence was no longer hidden, but was placed in the public domain.

The negative probabilistic concept

In 2003, following a string of financial scandals including those of Enron and WorldCom, Derek Higgs was commissioned by the UK government to review the role and effectiveness of non-executive directors. Higgs proposed that nomination committees should 'consider candidates from a wide range of backgrounds and look beyond the "usual suspects"'. He also led the Department of Trade and Industry to commission a report on the recruitment and development of non-executive directors (the 'Tyson Report') which explicitly recommended increased diversity in board membership, particularly with regard to female participation.

In addition, Higgs recommended that the nomination committee should consist of a majority of independent non-executive directors and should be chaired by an independent non-executive director. The nomination committee should lead the process for board appointments and make recommendations to the board. To stress the relationship between directors' independence and proper corporate governance the Combined Code also states that at least half of the board of each FTSE-350 company (excluding the chairman) should 'comprise non-executive directors determined by the board to be independent'. Higgs and the Combined Code entrenched independence according to the negative probabilistic approach more deeply by focusing on nomination of directors. Decisions made by a nomination committee would be independent of the board as long as and the to extent that its members are themselves independent. By recommending that nomination committees will be composed of non-executive directors, the committee introduced a structural-recursive element that, in effect, distanced the board from a position of responsibility and accountability.

By calling for a more diverse background from which directors are appointed, the Combined Code tried to offer a potential remedy to the 'negative' definition approach and its problems. The implicit assumption here is that if non-execs come from outside the social networks of the existing directors, it is more likely that they would be independent. The organisational tools that are expected to ensure a wide diversity of appointees are set procedures that firms must follow prior to appointments. The presentation of the probabilistic approach may seem like a solution but in fact it simply moves the 'negativity' problem to a different location. By demanding firms to appoint non-executive directors from 'diverse backgrounds' the Combined Code actually asks the firms to appoint non-executive directors from backgrounds that are different from those from which non-execs usually came. The combined code still does not provide a positive definition about directors' independence.

Assuming that there is a correlation between expertise and vicinity to the firm, simply asking firms to diversify their appointments is not likely to diminish the causes for the optimisation process that firms currently perform. If there is a correlation between the non-execs' expertise and their relative closeness to the firm, requiring that firms diversify

appointments is unlikely to remove this underlying trade-off.

Discussion

This brief history of development of corporate governance in Britain over the past 15 years reveals that although the independence of non-executive directors is considered to be an important precept of regulation and good corporate governance, the negative definition – bilateral and probabilistic – of independence leaves a number of important problems unresolved.

First, it constructs a public facade of regulation – where British firms are able to appoint directors without providing positive certification of independent status. Second, these definitions create a risk-laden trade-off between independence and expertise. Since independence is understood in restrictive terms as where the individual director is not connected to the firm, this enables firms to engage in a game of optimisation – in choice between the independence of a director and his/her relevant knowledge or expertise. It becomes probable, then, that companies prefer to appoint non-executive directors that are as expert as possible, but satisfy the minimal independence criteria.

In order to resolve this systemic vulnerability in the existing regime, it is necessary to formulate an improved model of corporate self-regulation. Instead of a binary classification of directors and boards of directors (where these are independent or non-independent in relation to a single organisation or person) it is possible to develop a definition that calculates the degree of connectedness of a non-executive director to the entire network of connections of boards. This conceptual view of corporate governance requires a methodological solution to assist assessments of independence. The fundamental distinction between a director's 'independence' and 'connectedness' is the focus of this exploration. In order to determine the degree of independence of a director in relation to a board, it is necessary to assess the strength and efficacy of the connections between an individual director and a specific board. In contrast, to measure the degree of connectedness of a director, it is necessary to map a wider network of connections between an individual director and other directors and establish how pivotal that individual is in maintaining the structure of connections among other directors and – through them – other companies.

What advances does this approach promise for corporate regulation in the future? The 'interconnected' view of corporate directors and boards enables us to develop a sophisticated and holistic analysis of independence and systemic risks. While an individual director might not be active in the executive operations of a firm, this is only part of the story. The interlocking position of that director in relation to other directors – and other boards – makes them crucial in relaying information between organisations. Therefore, analysis of the inter-board network of directors as an informational arena of transactions and exchange facilitates a more comprehensive and robust analysis of the degrees of independence and its consequence for regulation of corporate risk.

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