Independence–a growing fashion

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Introduction

Good morning. It is a great pleasure to be here and to be speaking at the first annual conference of the Portuguese Corporate Government Institute.

Shall we start with a question? Who is in favour of motherhood? I am in favour of motherhood. If it were not for my mother, I would not be here. Well, not just my mother. My mother, British Airways and the fast transport my colleagues arranged from the airport, a motorcycle chauffeur so fast that I think there were times on the journey when both wheels were off the road.

Now why motherhood? Because I think these days a lot of corporate governance is described in terms of motherhood. Motherhood that you cannot disagree with. Words like transparency, clarity, independence, respect for national differences, and other such expressions which are so obvious that you cannot really disagree with them.

But, my real questions here are:

- Where is the business value in all this?
- How does this actually help companies?
- How does this make better companies?
- How does this make more responsible companies?
- And, where is the practical guidance in putting all this into place?

So, I am going to take a couple of themes – including the theme of the emerging fashion for independence and try and look at some of those issues; pass on some perspective from the UK, and finish up with some information about where, from a UK perspective, there is real and useful practical guidance on how actually to put these things into practice.

Principles/Rules

My first perspective is the debate about principles and rules.

The US approach

We all know that the United States is famous for its approach to rules. Now, to some it seems that in the United States there are boxes that you have to tick, and when you tick those boxes

there are more boxes below those ones to tick, and even more boxes below those ones to tick. And, if you can tick all the boxes then you are in compliance, provided that your auditors can also tick the boxes and the boxes behind those boxes, at huge cost. Indeed I have seen estimates that the average cost for a US company of compliance with the Sarbanes-Oxley legislation is of the order of US$4 million per company for the first year. And it is uncertain whether that is the same amount for subsequent years or not.

But, in some senses, Americans are unapologetic about this. They are not sorry – It is a deliberate political reaction to Enron and other corporate collapses.

In fact William Donaldson of the US Securities and Exchange Commission was speaking in London recently and he was unapologetic about the restrictions governing the US capital markets. He said they are like the US Marine Corps and the US Army – very tough to get in and if you can't stand the pace that's tough too. For those of us who are old enough to remember the 'Hotel California' song by The Eagles you will remember well the expression that "it is rather like a hotel that you can check in but you can never leave". The accusation that the US is all rules based is perhaps a bit of a misnomer. Their rules, to be effective, are required to be deeply embedded in a Company's business, its organisation, its management and its culture – and so may achieve, by other means, at least some of the perceived benefits of the principles-based approach. Anyway, so much for the rules-based approach.

The UK approach

The UK on the other hand is known for the opposite approach – for the principles-based approach. And being English, nothing is exactly quite what it seems, and I have to admit that we cheat a little bit. Sorry to say that but it is true. When we talk in England of principles, it is because we divide our Governance Code between, in effect, principles and provisions. And at the end of the year you have to say how you have complied with the principles. You do not have to say "we are in compliance with the principles" – it is an explanation. Provisions that you do have to say whether you are in compliance with, and then you have to given an explanation if not. So, the English concept of "comply or explain" is quite subtle, and it is not quite the same as a straight compliance statement.

And then the cheating that I admitted to – for the first time this is not so much about corporate governance, but a Listing Rule. As a new part of our securities regulation we will have what are called 'Listing Principles'. These are six principles that all UK companies with a London listing of their equity must observe. But although they will be called 'principles' they are enforceable as if they were 'rules'. And that is where we cheat because we call them principles when they are actually rules.

The right balance

So, where is the right balance on these things? I think that you cannot answer this in isolation because the answer has to lie in whether it produces the right governance in substance. Perhaps whether you achieve that through principles or rules or in combination, does not matter. Maybe also in some sense it does not matter whether good governance is required to comply with law, regulations or guidance, or because it becomes practice; because, at the end of the day, it is the Company's reputation and its standing with investors and the community, and the reputation of its Directors that counts for the most.

Directors' Liability

Equitable Life

Now, Directors' Liability. Sorry to use these words here. In England this week a very important court case began. The Equitable Life Insurance Company is suing, in court, all its former Directors and its auditors for billions of pounds and it is claiming that these former Directors were negligent. And how were they negligent? They were negligent because they failed to take legal advice. Now you might say that I, as a lawyer, would regard it as entirely the right conclusion that Directors should be forced to take legal advice. But, I do not, because I do not think that is necessarily good business sense and nor do I really think it is the issue.

The issue is, that Equitable Life being an insurance company, the Directors relied on professional advanced actuarialadvice. The trouble was (some think) that the advice was so complex that the Directors did not understand it, or perhaps they just did not question it enough. And part of the claim is that actually the Directors in a way abdicated their responsibilities and effectively did as the actuary told them. As well as this Court case there are some other quite significant actions in the UK. Since April the law has been amended so that UK companies can effectively give very wide ranging indemnities to their Directors. This new law is deliberately designed to allow a company to indemnify its Directors against third party claims, such as US class actions. The extent to which the Directors can be indemnified by the company itself are more restrictive than those that applies to third party claims, but still much more flexible than the previous rules. The UK rules used to work so that the company could not pay the Director the costs of defending the claim until they won the claim. If the Director won the claim, he would have his costs back, but the time he really needed the money was before he had successfully defended the claim. So, that is a significant development in the UK context.

The Cardiff Savings Bank

In some senses there is a certain history about this and the history goes back to the 1800s. And it goes back to a savings bank. My partner Pedro Rebelo de Sousa has warned me to be very careful about what I say because here we all have savings in a secure savings bank. This one was the Cardiff Savings Bank and the case concerned the Marquis of Bute. And, he was appointed a Director. And he was a director for many years. But how old do you think he was when he was appointed a Director? 21? 18? 20? 12? 11? 9? 8? 7? No, he was 6 when he was appointed a Director of the Bank and then he remained a Director for the next 30 years.

And in that time how many Board meetings do you think he went to? These days a director would go to, maybe, 10 meetings a year – so 30 years' times 10 is 300 meetings? Perhaps a bit less? Cardiff was some distance from London where his main residence was. So, perhaps 250? No. (A bit less than that actually). So do you think it was 150 or even 50 – this is during 30 years remember. But it wasn't 20, not 10, and not 5. It was 1. And that was by mistake! He found himself in Cardiff and decided he would go to a Board Meeting. And he did.

Anyway, the bank collapsed. It was called, then, a "stoppage". The Bank shut its doors on its depositors. People were outraged. Even then the Directors were sued. But, it was 1892 – not 2005. The claim against the Marquis was that he had failed to fulfil the standard required for Directors, but the judge said "No, that he had met the standards required for Directors and that he should be acquitted".

Liability and non-executives

Now, we have clearly come quite a long way since then, or I hope we have. But – to put it into perspective in relation to Directors' liability issues – in the UK we face a conundrum: How do we attract more people to be non-executive Directors – more diverse people, from different backgrounds, more women and more people from different ethnic origins, …..but at the same time as having major litigation against people who are or used to be Directors. And, we have not solved that conundrum yet.

Independence

So I think that where this takes us is to the issue of independence and the increasing fashion for it. This fashion can be seen in a variety of ways. We can see it in relation to auditors and the independence of auditors, and requirement to disclose not just audit services but also other non-audit services. By the way, one of the things we are doing in England at the moment is to allow auditors to be liable only for the proportion of the fault that is theirs. For example, the auditors of Equitable Life are being sued badly. If they lose, they will be liable for the whole of the loss, not

just the proportion that was just their fault (if any). Then it is up to them to recover a just and equitable proportion from the Directors, if entitled to it.

So you can see the fashion for independence in relation to auditors and obviously the concept of independence also applies in relation to non-executive Directors. And here I think there are some important developments for Portuguese companies.

EU Recommendation

As you may know the EU Council made a Recommendation, published in February this year, in relation to non-executive Directors and in effect the structure of the Board of Directors. I should say that I do not come to this subject with a presumption that "British is Best". We are still learning after many years how to address these issues nor (and perhaps this will not surprise you since I am British), do I necessarily take the view that everything that comes from Brussels is best either.

But here is another conundrum because I think that the generally accepted consensus is that it is undesirable to have a single European Corporate Governance Code. There are too many differences even within the EU, and in particular differences between the single unitary Board and the two tier Board produces significant differences in governance. But, at the same time as some people are saying that we should not have a single code, others are promoting a convergence of codes which is moving us all towards having – if not a single code – a very common practice.

Maybe in some senses that is not so bad from an international company's point of view. They are more able to do business across borders. But whatever approach is adopted here it clearly has to be right for Portugal.

The definition of independence

One of the areas I suggest is particularly significant for you and which I think will produce significant changes is the definition of independent Directors. The CMVM's regulations already contain a definition of independence. But, at the moment that does not cover, for example, Directors who have been Directors for a more than a specified period. In the UK this period is 9 years and there is a presumption that after this period you are no longer independent. Note, this is a presumption, so it does not mean you do fall off a cliff after 9 years, but you have to defend your categorisation as independent more vigorously after 9 years.

There are some quite tricky issues about cross-Directorships in another company in the same sector. I think that in the UK this was probably one of the more difficult aspects of the combination of the various pre-existing codes into a single one was to come up with a single

definition of independence; and then to assess the impact on existing companies and whether the existing Directors complied with the new definitiion or whether there would need to be fundamental changes to the composition of Boards in order to have the requisite number of Directors who could be categorised as 'independent'.

The role of the Chairman

One aspect of independence which we have changed in the UK, but where there is debate as to whether we have got it right is in relation to the role of Chairman. Traditionally the Chairman has been perceived as an independent non-executive and his or her role used to be regarded as to lead the non-executive Directors. The new rules require that the largest companies within the FTSE 350, have at least the majority of the Board (excluding the Chairman) comprising independent non-executive Directors. And why is the Chairman excluded from this? Isn't he or she the most important person?

Well, the analysis in the UK was that if you looked at the remuneration of the Chairmen of the one hundred largest listed companies (the FTSE 100), their average remuneration, going back a year and a half or so, was over £400,000. It is hard to say that somebody who earns more than £400,000 a year is, even if non-executive, completely independent. So, for the purposes of deciding the composition of the Board for the FTSE 350 companies, you exclude the Chairman. So I think what we were trying to achieve was something fundamental: to move the Chairman into the middle – so you have a group of executives on your Board and you have a group of non-executives, and the Chairman fulfils a balancing role between your executives and your non-executives. There is still much debate in the UK to whether that is the right business model. For the largest companies it may well be, but I think you can appreciate that a Chairman who is balancing two parties on the Board has a rather different role to one who is effectively leading the non-executives.

Forthcoming Developments

Turning now to what's around the corner. Let us have a little heads up at some of the things that are coming in the UK, some of which because they are EU Recommendations will be coming your way too, soon I am sorry to say. In particular the EU Accounts Modernisation Directive.

Fair reviews

This has taken us all very much by surprise in the UK. The reason it has taken us by surprise is because tucked away in this Directive are twelve or so lines. The effect of these lines when you read them in conjunction with the Directives that apply to the accounts of banks and of insurance companies and to individual and consolidated accounts, is that (other than the smallest companies) every British company is going to have to produce what is called a fair review – a fair business review in their annual report. And in this fair review they will have to describe the principal risks and uncertainties facing their business and they will have to use something called KPIs. The mention of KPIs makes us shake; we are nervous of them. These KPIs are Key Performance Indicators. They are not just financial indicators but they are non-financial performance indicators. And by law, in the UK now, all British companies, apart from small ones, have to publish Key Performance Indicators and they have to cover human capital issues – i.e. people issues – and they have to cover the environment. The UK government estimates that approximately 36,000 unquoted companies will have to provide a fair business review. British quoted companies have to produce this fair review and much more in what are called mandatory Operating and Financial Reviews (OFRs). So in effect it is nearly the whole of the British business community. It also affects the British subsidiaries of Portuguese companies and British subsidiaries of American or German or other companies. The rules are slightly different for banks and insurance companies which are given somewhat less latitude. And then, being the English, we impose our own 'super-equivalent' requirements on top of these Directives on our quoted, British companies. They have to do additional reporting where they have to report not just on their principal risks and uncertainties but also on their strategy and the potential for it to succeed. So it is deliberately intended to make these British companies produce forward looking information, and that type of information comes with all the difficulties of forward-looking information in terms of legal liability and in managing expectations.

Those new rules applied for financial years first beginning on or after 01 April 2005. 01 April, April Fool's Day, was thought an appropriate day to use as the starting reference date.

So all in all it is I think a very significant development in the UK and because of lot of it is EU Directive-based.

Continuing disclosure of price-sensitive information

Another challenging issue we are addressing within the UK is the issue of continuing disclosure of price–sensitive information, or what will shortly become 'inside information' under the Market Abuse Directive (or as we call it the "MAD") by listed companies. This is another Directive of application to Portugal as well in due course. These are the rules that apply to listed and publicly

traded companies and the circumstances in which they have to provide information to the market where their own expectations of their financial performance change significantly. Or, where something happens in their business environment which has, in effect, a substantial impact on their business. And in UK the rules work in a way that once you have triggered an obligation to make an announcement you have up to 24/48 hours to make an announcement to the market. If you do not, the company and its Directors can be fined. And over the last year we have had, for the first time, several Directors who have been fined personally for breach of the rules.

Marconi

One of the best examples which I think illustrates the complexity of these requirements is Marconi. On Friday the Finance Director received updated management information. On Saturday he concluded that an announcement to the market was required. On Sunday he drafted that announcement. On Monday, at 9.00 am he sat down with the Chief Executive and discussed the financial figures. By eleven o'clock they had agreed that an announcement was required. And so after that they went off to try to get hold of the other Directors to hold a Board meeting. For a variety of reasons that we will not go into it was not possible to hold the meeting that day because insufficient Directors were available and they were negotiating a major disposal at the same time, itself also an announceable matter. The Board didn't meet until later on Tuesday and an announcement went out on Wednesday. Too late! the Regulators said. The company was criticised for that delay.

So if we put all these things together doesn't it seem to you that what it all really focuses on is the objective and timely supervision of companies? That I think is what is in question, not so much the detailed tests for being independent but whether in substance the focus is on objective timely management.

Practical guidance

So where is all this practical guidance? Well, in the UK, there is a variety of guidance. We now have in the UK a requirement that in each year a listed company must evaluate the performance of the Board of Directors, of the Committees of the Board and of the Directors themselves. It has been in place for about a year or more. This is also a requirement of the EU Council Recommendation on non-executive Directors that I have already mentioned. That recommendation is, by the way, supposed to be implemented by 30 June 2006.

How on earth do you do a Board performance and evaluation? And how do you do it without dividing or upsetting your Directors? Well that is the issue that is facing Chairmen. Many are using questionnaires and/or face to face interviews, some are using external consultants;

although those that have done it did it against my advice, because my own belief is that if a director has something to say to other Directors I think he or she should say it. There are a range of opinions as to how you should do the evaluation. My view is that if you look at all the propaganda about corporate governance, and there is an awful lot of it about, this performance evaluation is one of the bits that is really good value. It is of value for a Board to step back and say:

- How are we performing as a Board?
- Is the relationship between the executives and the non-executives working?
- Are the non-executives being constructive?
- Have we got our strategy right?

So there is guidance on how to do a Board performance. We certainly run sessions on how to do evaluations and there is a certain amount of sort of sensible practicable guidance on how you do them.

Anyway, I do not think this has to apply to a listed company only. I think there is a presumption that corporate governance is for listed companies, but a lot of it is useful for unlisted or private companies and Government and the public sector. Indeed I think there is quite a lot for the private sector. One can sometimes learn from the profit of the private sector but that is something for another day.

My own experience is that one of the key elements for a Board is the way they manage the information, increasingly a major problem. I find it increasingly difficult to take in large amounts of paper in presentations. Especially if they are given to me at the last moment. So from a Directors' point of view that is dangerous; because if something goes wrong people will look at the paper that you had and assume that you read it, understood it and that you have asked all the questions you wanted to do. So I think that from the Board's point of view managing the process of information so to ensure that Directors get timely reports with polished information is essential for good operation of the Board, but also from perspective of the protection of the Directors from liability. And I do not think that is just a particular English point of view. I think it is of universal preoccupation.

I think that Boards are well guided in having effective processes for managing their communications. It is key to ensure that if an announcement needs to go out Directors are available and a notice can be prepared quickly and effectively and responsibly.

And that I think is probably a variation of the theme that we are increasingly seeing, both in the UK and elsewhere. Increasingly Directors put in place systems and controls to protect

themselves. And systems of control are wonderful, provided they work. And if they work they are great because they work. But if they do not they are helpful because you follow the process and then you work down and that is where the buck stops. So systems of controls are good.

So just to conclude, other sources of guidance that are available: What I have found useful are the very sorts of guidance on the role of non-executives, the role of a non-executive strategic their role in constructively testing, supporting and questioning but not questioning in a way of sort of destructive way. Very difficult values to achieve. There are standard questionnaires for Board Committees, for remuneration, for audit and for nomination committees. There are checklists for people who are about to become non-executive Directors and the sorts of questions they should ask. There are sample appointment letters that set out the sort of things that a non-executive's role should cover, and including their remuneration, their insurance, their time commitment and then there is other guidance we have produced in terms of check lists for announcements and controls and things like that.

A lot of this is universal common sense and if you need help you can please ask me or one of my colleagues and we can point you in the right direction.

So I think this is all that I wanted to cover in terms of the independence. I think that has been a broad overview. Thank you.

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