



# If Lightning Strikes. . .

The evolving role of the Senior Independent Director



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## ■ Executive Summary

The Senior Independent Director (SID) is now firmly established as an essential feature in the UK corporate governance landscape.

The revised UK Corporate Governance Code, published in May 2010, extends and clarifies the SID's role, and includes new language about its scope and purpose.

The code revisions were based on a year-long consultation process which established broad support among investors and directors for the position.

It was not ever thus. When Sir Derek Higgs proposed in his 2003 report that boards formally name a senior independent director, his recommendation attracted intense criticism.

To many business commentators, the move threatened to create an unnecessary centre of power on the board, challenge the legitimacy of the chairman, and confuse relationships with institutional investors.

Since then, however, the role has made a highly successful evolution and has also been widely adopted across a range of other organisations in the public and not-for-profit arenas.

This paper, informed by our daily conversations with chairmen, SIDs and other directors of companies of all sizes and operating across all sectors, examines the challenges of the SID position.

It looks at the formal aspects of the role, now more clearly defined, but also some of the informal responsibilities. It asks whether the SID should be a natural successor to the chairman, and what the requisite qualities of a strong SID are.

It concludes that at a time when boards are coming under ever more scrutiny, SIDs play a vital part in enhancing board effectiveness.

Truly the senior independent director has come of age.



## ■ A Role Under Review

The position of senior independent director was first formalised by Sir Derek Higgs in his 2003 report on the role and responsibilities of non-executive directors. His recommendation that companies identify a SID accounted for a mere five paragraphs of his 125-page report but generated huge controversy.

Critics charged that this measure threatened to create an alternative centre of power on the board, challenge the legitimacy of the chairman, and confuse relationships with institutional investors.

Fast forward to the present day, and attitudes have changed. In 2009, the Financial Reporting Council undertook a year-long review of UK corporate governance to ensure it remained fit for purpose in the wake of the financial crisis. The review found widespread support for the SID's role.

Summarising discussions with the chairmen of quoted companies, the FRC reported that it found: "A lot of support for the senior independent director role as currently practiced."

Investors, too, backed the role. The National Association of Pension Funds, whose members control assets of £800bn, said: "We note particularly the evolution of the role of the SID into a valuable contact point for shareholders."

The SID's role also came under scrutiny from Sir David Walker in his government-sponsored review of the corporate governance of banks and other financial institutions.

Sir David noted that the SID's duties are often seen as being largely outward-facing in nature, namely to be available to major

shareholders who require an alternative channel of communication.

But his report emphasised the equal importance of the SID's internal role, namely to referee potential or actual conflicts between the chairman and CEO or to ensure that the non-executive directors are contributing and challenging effectively.

## ■ The Formal Job Description – A 'Negative Charge'

The UK governance code, updated as a result of the Financial Reporting Council's review, sets out the board's obligation with regard to the SID as follows:

"The board should appoint one of the independent non-executive directors to be the senior independent director to provide a sounding board for the chairman and to serve as an intermediary for the other directors when necessary.

"The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or other executive directors has failed to resolve or for which such contact is inappropriate."

[The UK Corporate Governance Code A.4.1]

The description of the SID as a "sounding board for the chairman" is new to the code and offers a succinct summary of a critical aspect of the SID's role. The chair's position can be a lonely and stressful one, and the SID can be a useful confidant and supporter.

The SID can also act as the chairman's eyes and ears, tracking the complex and sometimes overlapping work of the committees and keeping the chairman informed of potential trouble spots.

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The SID's position as the go-between for both the chairman and the rest of the non-executive team is equally important. Sir David Walker described the SID as "serving as trusted intermediary or lightning conductor for the NEDs when necessary."

While aiding boardroom communication, it is equally the SID's job to guard against complacency. Sir David concluded: "Given the inevitable tendency towards collegiality in boards, but which ceases to be healthy where excessive deference to colleagues, in particular the CEO, stifles critical enquiry and challenge, the SID should be the potentially negative charge on the board."

## ■ The Alternative Route

The SID's role as a contact point for shareholders only comes into play in times of trouble. Summarising its discussions with company chairmen, the Financial Reporting Council said that: "The SID was described on several occasions as a 'safety valve.'" Or, as one chairman told Sir David Walker's review: "The SID is the person you need to have and hope you never have to use."

The Association of British Insurers, whose members speak for about 12% of the UK stock market, said: "The SID should have a specific role in times of corporate stress or where there is contention with the shareholder base. The SID should go out and discuss shareholder concerns and report back to the board as a whole."

Large institutional investors will generally only engage the SID directly in the event that they have lost confidence in both the chairman and chief executive. This is a rare occurrence, but poses potentially dire consequences for the company. Boards can be left leaderless if both the chairman and chief executive are viewed

by shareholders as underperforming, and it can take valuable time for the non-executive directors to organise themselves to deal with the crisis.

The code makes it clear that, in this situation, responsibility rests firmly with the SID to take the lead and provide a figurehead around whom the non-executives can rally and mount restorative action.

In this, as in many aspects of the SID's role, a deft touch is required. If relations between the company's leadership and large shareholders have broken down, then the SID must act decisively and be ready to voice opinions that the board may not wish to hear.

The SID must also be sufficiently close to shareholders to ensure that he or she is aware of any simmering discontent without interfering with the normal chairman-chief executive relationship with investors.

## ■ Appointing The New Chairman

Perhaps the most critical role of the SID is to take the lead in appointing a new chairman. In the past, this process was often masterminded by the outgoing chairman or the chief executive, but this is no longer considered good practice.

The succession issue is complicated if the SID puts his or her name forward as a candidate. As the most senior non-executive director, the SID will always be a compelling internal candidate. However, the elevation of the SID to the chairmanship poses problems. The moment the SID declares their candidature for the chairmanship, they are immediately ruled out of membership, let alone chairmanship, of the nomination



committee, requiring another non-executive director, perhaps one with less experience, to take over.

Furthermore, if the SID fails to secure the appointment of chairman they may feel under great pressure to resign their board membership, perceiving it as a vote of no confidence in their abilities. The company thus faces appointing both a new chairman and a new SID at the same time.

This is not to say that the SID should never be considered for the chairman's seat. In 2009-10, there were 110 chair appointments at FTSE 350 companies. Of these, 16 saw the promotion of the SID to the chairman's seat. All told, 44 FTSE 350 chairs have previously been SID at the same company.

The SID, by his or her very nature, is likely to be a person with many of the characteristics sought for in the new chair. If that is the case, and if the individual offers themselves as a candidate, it would be wrong to rule them out. As the figures for SID-to-chair promotion in the FTSE 350 indicate, however, the transition is not common and should be considered the exception rather than the rule.

In this respect, the SID position should not necessarily be viewed as a holding role for a 'chairman designate.' The SID's duty both to evaluate the current chair and to monitor the relationship between the incumbent chair and chief executive could be called into question if the SID is seen as the chairman in waiting.

## ■ Appraisal Of The Chairman

One of the SID's central duties is to conduct an annual appraisal of the chairman's performance. The SID's diplomatic skills will be to the fore in handling this task. Completed properly, such a review can enhance the performance of the chairman and contribute significantly to board effectiveness. To be valuable, however, the SID needs to ensure the appraisal is robust, fair and constructive. Once again, the SID must be both thoughtful and disciplined in his or her approach.

The SID is also the best-placed person to tell the chairman that their time is up. It is a natural human failing in organisations of all sorts for the head to be reluctant to stand down – there is always one more job to do. Chairmen are not immune from this phenomenon.

Chairs who are not past their sell-by date can also underperform; it is the SID's job to confront this problem promptly. Effective SIDs will recognise when action needs to be taken. There are times when a chairman has to lead the board to decisions which may be correct, albeit unpopular. On other occasions, chairs are capable of forcing through poorly thought-out decisions. The best SIDs knows the difference.

SIDs should also track the all-important relationship between chairman and chief executive. At one end of spectrum, this leadership pair can develop a relationship which is too close, perhaps even seeking to control the outcome of board meetings between them.

At the other end, the chemistry between the two fails completely, making the relationship unworkable. The SID needs to keep a watchful eye on the chairman-chief executive relationship, to make sure it is neither too cosy nor too combative.

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## ■ What Makes A Good SID?

The SID's role is a delicate one – it is important that they remain invisible unless and until they are needed. They must be close to vital decisions and relationships but not so close that they tread on the chairman's toes. And they must be content to have a backseat role while things are going right.

What are the qualities of a successful SID? Arguably, they should have chairmanship experience of a similar sized company but have no desire to be chairman of the company which they serve as a SID. Among the current FTSE 350 index, the SIDs of 48 companies are also chairmen of other FTSE 350 organisations.

Clearly, the SID should have the capacity to shadow the chairman in times of emergency but, at the same time, the SID has emerged as a specific role in its own right, with the best SIDs displaying an identifiable set of attributes.

Many of these qualities are the same as those possessed by the best chairmen, though not everyone has the desire to assume the burdens and pressures that are an inevitable part of the chairman's role. These people have the capacity to make excellent SIDs and board committee chairs.

## ■ Chairman Concerns

Senior independent directors have made significant strides in defining their role and using it to enable better board function. Yet considerable wariness remains on the part of the chairmen.

Anecdotally, we have found that nearly every chief executive and company secretary supports the idea that the SID

should be the main point of contact when the non-executive directors had concerns about the chairman. By contrast, a far lower proportion of chairs agreed with this statement.

Similarly, chairs were far less comfortable about the idea that the SID should monitor the relationship between the chairman and the chief executive. In our conversations with chairs, nearly half said it was not the SID's role to manage a dispute between chairmen and chief executive.

Some of these concerns may well be overcome by the passage of time. The stature and prestige of the SID has grown enormously since its formal introduction in 2003, but further progress is required before the important contribution of this role is universally recognised.

## ■ A Sound Investment

Once viewed with suspicion and concern, the role of the SID has matured into an important feature of governance on the board.

The role continues to evolve. The SID's responsibilities have traditionally been seen as outward-facing in nature – principally to act as a contact point for concerned shareholders who are unable to get satisfaction through the normal channels of communication with either chairman or chief executive.

As the revised UK Governance Code and Walker Review make clear, however, a critical aspect of the SID's role is inward-facing, namely to support the chairman, act as an intermediary between the chair and the rest of the non-executive team (where necessary), and guard against board cosiness.



Where a board is unable or unwilling to pose sufficient challenge to the executive team, or has become too deferential, it is the SID's role to act, in Sir David Walker's evocative phrase, as "the negative charge on the board."

Many SIDs will find that they are never required to fulfil the 'crisis management' aspects of the role. Aside from formal activities, such as leading the evaluation of the chairman or taking charge of the nominations process to select a new chair, SIDs at well run companies with effective boards may see little distinction between their position and that of the other non-executive directors.

As described, the SID is the "safety valve" whose presence only comes fully into its own at times of corporate stress.

That should not be seen as diminishing the importance of the SID's position. As with many aspects of boardroom life, the strength of the board and its processes are only truly tested when problems arise.

It is then that investing in a strong SID truly pays dividends.

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## ■ About Odgers Berndtson

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## ■ Our People



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