

## **REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS**

### **Response to the consultation document by Barclays Global Investors Limited**

The views in this response are those of Barclays Global Investors in their role as an institutional investor.

#### **A: Role**

##### **What role should non-executive directors perform, and how does this compare to the present position?**

###### **1. What is the role of the board? What is the role of the chairman and how does it relate to the non-executive directors?**

The role of the board is to guide the company in its function of creating wealth for the members, that is, shareholders, of the company. The chairman's role is to manage the board. The chairman will have a unique relationship with both executives and non-executives and so can probably never be deemed independent. The chairman must ensure that all relevant matters are put to the board for consideration and must encourage good debate by exercising appropriate skills as a facilitator. Relevant matters include strategy, corporate actions such as acquisitions, performance of the company, succession planning, risk, both financial and non-financial, measuring the performance of the board itself, and so forth. The chairman must also ensure that the material provided for board discussion is of the highest quality and delivered in time to allow analysis.

The chairman should identify skills gaps on the board, whether amongst executives or non-executives, and initiate recruitment to fill them. The chairman is also responsible for maintaining the balance on the board so that no one individual or group wields excessive power.

The chairman must make sure that the non-executive directors play an active role as members of the board, that they have training and any support as necessary. This includes the opportunity for non-executive directors to meet other executives in the company without the presence of board executives.

The chairman should be aware of other obligations of non-executive director in case these compromise the attention they can give to their board responsibilities.

###### **2. What should be the key roles of non-executive directors on the board and what should be the balance between the different components? Within a board, should all non-executive directors be expected to fulfil each of the different roles?**

The overarching role of the independent non-executive director is to ensure that the company is run in the interests of the members. Within that the key roles include: providing input into the debate on strategy, challenging the executives on tactical proposals, demanding comparative analysis with competitors, monitoring performance, of executives, especially the chief executive and finance director, and the performance of the business as a whole, being available for executives to exchange ideas, succession planning, establishing appropriate executive remuneration, resolving any conflicts of interest that may arise with the executives, providing contacts for the company. The monitoring role of non-executive directors also includes oversight of the audit via the audit committee, ensuring appropriate risk controls for the company are in place, ensuring compliance with regulations and standards of best practice. Communication with shareholders is a role that arises from time to time when circumstances dictate, such as when executive management fails or shareholders need to raise concerns on, for example, executive remuneration.

Since the overarching role is a monitoring one this aspect is likely to be dominant. However the other functions, such as input to strategy, the challenging of the executives, informal communication with executives are so important that the functions should not be very unbalanced. It is important to note that non-independent non-executive directors may also provide a valuable input to strategy and other board function. All non-executive directors should be competent to debate strategy, finances, risk and so on. However they will have different strengths and experience which can be used to best effect in the board committees or in specialised discussions.

**3. How does this compare to the present position?**

Externally there is more focus on the monitoring role but in practice we suspect that a board will demand a significant non-monitoring contribution from any non-executive director. There is currently little contact between shareholders and non-executive directors unless specific circumstances require it.

**4. How independent do non-executive directors need to be for the different roles?**

The independent non-executive directors are seen as the representatives of outside shareholders on the board so it is important that they are responsible for remuneration. Independence is also critical on the audit committee though it is reasonable if a director representing a large shareholder, who is therefore not independent, is on this committee. Independence is largely a state of mind and it is difficult for outside shareholders to judge how independently a non-executive director behaves, whether they are deemed independent or not.

**5. What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a role in protecting the interests of the company? What can be done to help non-executive directors to be effective in relation to these conflicts?**

In the case of a management buy-out the independent non-executive directors will ensure fair treatment of external shareholders. They also have a role where a director is connected to an organisation seeking a commercial relationship with the company. They will safeguard the interests of the members of the company if the company turns down an opportunity which is then exploited by a director. If there is a large stake held in the company, whether by a family or other group, the independent directors must ensure that decisions are taken in the interests of all shareholders. In such situations it would be helpful if institutional shareholders were available to discuss these matters and give support to the non-executive directors. The risk is that this may be perceived as divisive on the board and may inhibit debate. This reduction in transparency would not be in shareholders' interests.

**6. What time commitment is needed for the role of Chairman and for non-executive director roles, and how far does this vary between different companies? Are there any implications for the number of non-executive posts that one person can sensibly take on?**

The time commitment for a chairman is difficult to assess. In normal circumstances a non-executive chairman would probably not require more than one or two days per week. This will increase if there is a major corporate action or a search for a new chief executive taking place. In some companies the chairman takes an "ambassadorial" role, meeting potential customers and contacts, especially overseas. Such roles will require more time commitment. The level of pay for the chairman is an interesting feature. Many non-executive chairmen receive more than the full-time chief executive of mid-cap companies. The time commitment for non-executive directors will vary within the board and is also dependent on the complexity of the company. It is partly dictated by the basic functions of board membership: analysis of material prior to the board meeting, the meetings themselves, attending board "away-days", visiting company locations. Assuming ten

meeting per year, two to three days for preparation and the meeting, one day for meeting shareholders or analysts (see 23 below), one “away-day” and two site visits, that is perhaps 34 days per year. Members of board committees will need extra time overall but the remuneration committee will require more if there is, for example, a review of incentives. A highly complex, large company will require longer meeting preparation and more days for site visits and contact with non-board executives.

From this analysis it is clear that too many commitments will lead to reduced function on the board by the non-executive director. This may be because of insufficient analysis of board papers, lack of availability for board meetings or insufficient time to learn about the business in depth. It is not only other directorships that are important. Positions on public boards, political appointments or any other regular commitments are relevant here. If the non-executive director is an executive in another company then only one non-executive director role is practical.

**7. Should there be a special role for a “senior independent” non-executive director?**

The low level of contact between non-executive directors and institutional shareholders may have led to a lack of support for this role. Shareholders tend to regard a non-executive chairman as the contact point to raise issues about executive performance. If the chairman is executive then an independent deputy chairman would fulfil the function. When a situation requires communication between shareholders and independent non-executive directors then one such director could be nominated as contact for the duration. We have not generally found a need for a senior independent non-executive director.

**8. Do you have comments on the proposed statutory statement of directors’ duties, which does not seek to distinguish between the legal duties of executive and non-executive directors?**

All directors should have the same legal duties.

**B: Attracting and appointing non-executives**

**What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?**

**9. What are the key skills, knowledge and experience which are needed by non-executive directors to perform the the role effectively, and how is this likely to change over the next, say, 10 years? Are some skills essential and, if so, what are they?**

All directors should have a working knowledge of finance and accounting, company law and regulation, and business strategic theory. They should be able to communicate well so that they can contribute effectively to debate. Experience will be and should be varied on the board. It is acceptable if one non-executive director has no previous experience of a board as long as the other members are experienced. If a non-executive director is chosen because of particular experience or contacts they should still have the basic skills in order to challenge the executives adequately. Non-executive directors drawn from outside the commercial world may require training. In the wake of recent financial scandals accounting skills may become even more important.

**10. What personal qualities and attributes are needed?**

A non-executive director should have

- Independence of mind and the will to resist pressure from executives and maybe the chairman
- Good judgement of individuals and commercial proposals
- The courage to challenge a view, even as a lone voice
- The ability to work in a team

- The time available to meet the commitments of the role
- Integrity, even if it means resigning on a point of principle or disclosing key facts to stakeholders.
- A record of success in other roles
- A willingness to continually learn

**11. What sort of mix of experience and attributes is desirable on a Board? Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.**

Diversity is key to the effective functioning of the board. The non-executive directors should not all be, for example, lawyers, accountants, marketing specialists, or even from the same industrial sector as the company. A larger company will require more diverse experience on the board while a smaller company with a smaller board will not have such a pool. Whatever the background they will all require the basic working knowledge in 9. above.

**12. How easy is it to recruit non-executive directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?**

We hear from companies that it is difficult to recruit non-executive directors. Advertising non-executive positions would increase the number of possible candidates. At present a lack of diversity may be self-perpetuating as a board might choose a new non-executive director with a similar background to their own, or from their existing contacts. Advertising to a wider audience would bring candidates from areas where the directors have no contact. Whatever the background the non-executive director should have necessary basic skills or training should be available. The independent non-executive directors are as important on the nominations committee as on other board committees. They should ensure that new non-executive directors are not sourced only from the chairman's circle of contacts.

**13. What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?**

Advertising positions would be helpful, see 12 above. Perhaps the largest potential pool is within the top 250 companies. We understand some companies are reluctant to allow their executives below board level to have external appointments. It would be beneficial to the company and the wider community if executives were encouraged to have an outside role, whether as a non-executive director, a local councillor, school mentor or JP. The executive would bring extra experience into their main employment and enhance their own development. Similarly, serving civil servants as non-executive directors may take commercial experience into their "day job". Employee-nominated non-executive directors are unlikely to be deemed independent if they represent only one stakeholder group. One major constraint on the number of candidates is the limited number of people with enough time to devote to the board while also working full time elsewhere. A second constraint is the concern about legal liability attached to the role. International representation is useful for the company with operations overseas. Such companies probably have appropriate board representation already. Otherwise it is no more valuable a pool of candidates than any other.

**14. Are the rewards for non-executive directors appropriate, both in terms of levels of pay and the form that remuneration takes – e.g. cash/shares/share options? Are current pay levels a significant factor in whether good non-executive directors can be attracted?**

Cash values of fees are probably too low and have not kept pace with increased responsibilities. The appropriate level of pay is not easy to judge. A modest level may be enough to attract candidates from academia or other public roles but may not be enough to attract senior executives or retired executives from the top 100 companies. If the fee is too high then it is more meaningful to the non-executive director. This may compromise their independence if they are then unwilling to resign on a point of principle and relinquish the fee.

We would expect non-executive directors to hold shares in the company and part of their fee can be in shares. These should not be saleable while the non-executive director remains on the board. Shares should not form the entire fee because that would exclude candidates who were not wealthy enough to forego cash income.

Independent non-executive directors should receive a fixed fee for a designated term of office. They should not receive contingent pay or performance fees as this may affect their decision-making. Therefore options should not be awarded because they are “geared” remuneration. However in very rare cases it may be necessary for a company to give non-executive directors options if it has no cash resources to pay fees.

If non-executive directors execute a one-off project that significantly increases the time they commit to the company then they should be paid an extra fee. This should be clearly communicated to shareholders, preferably at the start of the project. Any fee that looks like a “transaction bonus” is likely to be rejected by shareholders.

The perceived risk of personal legal liability may be too great for any fee to adequately compensate.

**15. Do you have comments on the issue of risks or insurance provision for non-executive directors?**

Adequate insurance must be provided or non-executive directors will be neither retained nor recruited. The situation at Equitable Life has publicised the fact that most insurance policies do not cover legal action brought by the company against former directors.

## **C: Structures and accountability**

**Do existing structures and procedures facilitate effective performance by non-executive directors?**

**16: How is the Combined Code working in practice? In particular, how are the provisions on the balance between executive and non-executive directors and the role of independent non-executive directors working? Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?**

We believe that the Combined Code works well and is broadly accepted by both shareholders and companies. The Code has influenced corporate structure, for example, nearly all directors now face regular re-election by all shareholders and the majority of companies have at least one third of the board made up of non-executive directors. If the chairman is described as “executive” or the roles of chairman and chief executive are combined then the function of the non-executive element on the board is even more important. Independence of non-executive directors is the key issue yet it is the most difficult for outside shareholders to assess because it is very much a state of mind or attitude. The main reason for non-executive directors to be deemed not independent is length of service on the board. A director who has worked with a board for nine years could be considered to have lost some independence of thought. However company secretaries give us examples of directors with 20 years service who still carry out their duties with rigorous independence. On the other hand a company secretary recently told us that a non-executive director should not be regarded as not independent just because he was the chairman’s brother. We support the NAPF/ABI guidelines on independence

though we would suggest that a non-executive director related to any other director, whether executive or non-executive, would not be independent.

In keeping with the Code most non-executive directors receive a fixed fee and very few receive options. We suspect that on some boards non-executive directors, especially on board committees, may not be free to appoint their own consultants to help them, for example, on executive pay.

**17: Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors? Are board meeting procedures working effectively? Do you have comments on board size?**

It is difficult for outsiders to know how the board and its committees function in practice. The members of a remuneration committee should be independent but we occasionally suspect that powerful executives on a board have put pressure on the non-executive directors to propose a particular remuneration structure. See also our comment on the appointment of consultants in 16. above. We have found that sometimes the chairman of the remuneration committee does not understand a proposed incentive scheme, especially if it is particularly complex. Unfortunately consultants may receive a higher fee for a more complicated proposal.

While we cannot assess the procedures of the board meetings we do question the company secretary on such topics as frequency of meeting, monitoring of absences from meetings, the timing of sending out board papers and so forth. We also find it useful to ask, when appropriate, whether the board ever overrules an executive chairman. There is a wide range of board size and the size of the company may not be a factor. Too large a board is inefficient for full board debate and too small a board will also not generate good discussion. For preference there should be more executives than just the chief executive and finance director on the board. This ensures non-executives have a broad exposure to executive input.

**18: Do you have comments on the composition and duties of Audit Committees? How effectively are Audit Committees working in practice? Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?**

The Combined Code guidelines on the composition of the Audit Committee are still valid, that is, all members should be non-executive directors, with the majority independent. It is logical that the non-executive appointee of a large shareholder, who is not independent, should be on the committee. Therefore a requirement that all members are independent is not practical. There are a few examples of executive directors on Audit Committees and shareholders express their concerns in such cases. It is now appropriate that shareholders take a stronger voting line in such situations. We assume that the Audit Committee can meet with auditors when they wish but it is impossible for outsiders to confirm this. It might be useful for the Audit Committee to publish a brief report annually, to include an outline of their process, the number of meetings with attendees and a review of the auditors' ongoing role.

**19: Similarly, do you have comments on the composition, duties or operation in practice of Nominations and Remuneration Committees?**

The Nomination Committee: it is logical that executives are included though they are responsible for both executive and non-executive appointments. The process for recruiting non-executive directors can be improved, see above for our suggestions. Shareholders would welcome more transparency in the functioning of the Nomination Committee.

Remuneration Committee: all the members should be independent non-executive directors and the chairman of the company must not chair the committee. The committee must be strong enough to resist an overpowering chief executive. All committees should be able to appoint their own consultants at the company's cost. They should have the

services of the company secretary to direct them on law and best practice. Again it is impossible for outsiders to judge the function of the committees.

**20: What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?**

Board appraisal is vital but little is disclosed on the assessing the performance of the board and non-executive directors. Some detail is given within remuneration for performance of executive directors in the managerial roles rather than as board members. Some individual performance is measurable, such as meeting attendance. Judgement of someone's performance at a meeting is subjective. The chairman should initiate a process, which may involve the use of external consultants, for both board and individual performance.

**21: Could more be done to review performance? Should more information on board performance be reported to shareholders? Should companies provide more information on the performance of non-executive directors?**

Attendance records for meetings could be reported. The ultimate performance target for the company as a whole is that against a suitable peer group, whether measured in share price, return on capital, profit growth and so forth. This should be reported to shareholders anyway.

**22: Are non-executive directors able successfully to challenge executive decisions or expose serious problems? Should it be made easier for them to do so and, if so, how?**

Again there is a problem for outsiders monitoring the functioning of the board. The overpowering or bullying chief executive will always need strong non-executive directors to challenge proposals. Non-executive directors should always have the opportunity to meet executives without the chief executive being present. The requirement for the non-executive director to have basic skills will ensure that at least they have suitable knowledge to challenge executive decisions. The chairman must manage board structure to prevent excessive power resting in executive hands.

If non-executive directors are concerned that executives on the board prevent them from carrying out some of the duties they should be able to approach major shareholders to discuss the matter. It may also be appropriate for the non-executive directors to approach the company's broker or advisor in such a situation. However the advisor may be conflicted if they regularly advise executives on corporate activity.

## **D: Relationships with shareholders and others**

**Do existing relationships with shareholders or others need to be strengthened?**

**23. How well do relationships between non-executive directors and shareholders and stakeholders work, and could they be improved? For example, we would be interested to hear views on what the relationship might be between non-executive directors and institutional shareholders. How could this relationship be strengthened?**

We believe that there is little contact between shareholders and non-executive directors. Institutional shareholder meetings generally involve the executive directors. Contact with non-executive directors is largely confined to situations where something has gone wrong. Shareholders may meet the non-executive directors to tell them they have lost confidence in the chief executive or the non-executive directors may be involved in meetings during the course of a hostile bid. The members of the remuneration committee will discuss proposed incentives with shareholders.

We do not believe that regular contact, such as an annual meeting, between shareholders and non-executive directors is necessary. An occasional meeting would be useful to give

shareholders an insight into the working and process of the board. It may be practical for the non-executive directors to meet several institutions together. The group of shareholders known as the Corporate Governance Forum has arranged such meetings in the past. We do not want non-executive directors to spend a disproportionate amount of time in such meetings in the normal course of events.

In our experience we have found it is often difficult to gain access to non-executive directors. They usually do not have an office at the company in question and a contact telephone number may not be immediately available. Such an enquiry may also alert the company if the shareholder is trying to raise concerns with the non-executive director. We believe that some non-executive directors do not see it as their role to have such contact with shareholders. The chairman or chief executive may be reluctant to facilitate such meetings. If there were a code of practice clarifying this aspect of the role it would be useful. This could be added to the Combined Code.

There is one line of potentially useful contact for non-executive directors that is probably not used at present. This is with City analysts. An occasional "off the record" meeting between an analyst and a non-executive director may provide the non-executive director with ideas and concerns that had not been raised in the boardroom. It may also provide extra information about the company's competitors.

**24. To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more that they could do, by promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows, or otherwise?**

Outside shareholders will not be able to judge this effectively. One of the chairman's roles is to act as facilitator in the board meetings, ensuring that all board members can and do contribute to debate. The chairman should also establish a scheme whereby non-executive directors visit different locations of the business. This is especially important when they first join the board but it should also continue through the period of office. The chairman should also make sure that non-executive directors are not prevented from talking to shareholders.

**25. What should be the relationship between non-executive directors and executive directors, and with senior management? What should their relationship be with the chairman and the Chief Executive? What should their relationship be with key advisers to the company?**

Non-executive directors will have contact with both executive directors and senior executives. However much contact there is their independence should not be compromised. Non-executive directors should feel able to raise concerns with the chairman. They must be aware of their role of monitoring the performance of the chief executive and effectively challenging his/her proposals. The non-executive directors on the board committees should appoint their own consultants as necessary. The audit committee must have a relationship with the auditors that can exclude the finance director. It would only be appropriate for the non-executive directors to approach the company's broker or financial advisors perhaps in a whistle-blowing situation.

**26. How can Company Secretaries support effective performance by non-executive directors?**

The role of company secretary is key to the functioning of the company and the board. Ideally the company secretary should be responsible only to the non-executive directors and should provide the secretarial function at all the board committees. The non-executive directors should be able to use the company secretary to hire and pay for any consultants required. The company secretary can also be a conduit for communication between shareholders and the non-executive directors when contact details for the non-executive directors are not readily available. It would be best if the company secretary

could only be dismissed by a unanimous board decision. In small companies we recognise there may be a problem because often the finance director is the company secretary. This is probably unsatisfactory but the cost of two full time roles is prohibitive.

## **E: Support**

### **How can non-executive directors best be supported to perform their role?**

**27. How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?**

Non-executive directors should visit company operations in order to learn more about the company and to listen to non-board management. A non-executive director who is not familiar with the operations of the company and whose only contact is the board is unlikely to contribute fully to board debate. Speaking to a broad range of management may provide insights into the company and its competitors not revealed in the board papers. External shareholders are not able to judge whether communication channels are unrestricted. In one example a chairman told us that the chief executive was unhappy if the non-executive directors tried to meet operational management.

**28. What training and development opportunities are available? Could they be improved and, if so, how?**

There are some training schemes available, such as those offered by the NAPF and certain management colleges. The Institute of Directors also offers a qualification for directors. If the role of the non-executive directors were to be included in the Combined Code it would clarify some of the duties. It would be helpful if companies disclosed training opportunities for board members. However at this level of achievement there is some resistance by individuals to training or learning in the belief that their experience is their training?

**29. Can induction for non-executive directors be improved?**

We are not privy to the details of induction offered but we suspect it could be more thorough. It should include guidance on duties, visits to company operations and agreement on performance expectations. If the non-executive director does not have a corporate background then training in, for example, accountancy may be required. One of the training courses would be useful if the individual has not previously completed one independently.

**30. Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?**

We suspect that they generally do not get adequate guidance or feedback. The chairman of the board should initiate improvements in these areas, with the help of the company secretary.

## **F: Smaller listed companies**

### **In what ways is the position different for smaller listed companies?**

**31. To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?**

A small company will generally have a small board which has implications for the board committees. Such companies may gain even more by using any training schemes that are available. Some requirements still apply to small companies, such as independence and contact between non-executive directors and non-board management. Some small companies rely on existing contacts, such as their lawyer, to be non-executive directors.

This is probably not satisfactory. See also our comments on the role of the company secretary in 26 above.

## **G: International context**

### **What can we learn from international experience?**

#### **32. What lessons can be learnt from international experience, either in terms of structures or behaviours?**

Recent experience has offered several lessons. While US corporate governance has positive aspects the lack of a range of executives on the US board is probably a negative feature. It can limit the exposure of the non-executive directors to executive discussion. We may be able to learn something from the Swedish experience of using employees as non-executive directors.

#### **33. Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?**

We believe the UK board structure is broadly satisfactory.

#### **34. Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?**

This would not be beneficial. The UK has made great strides in corporate governance in recent years and recent corporate events, such as those in US, do not suggest something better. Many jurisdictions, especially in Europe, do not have funded pension schemes and therefore there is little domestic shareholder power. Many board structures may reflect this and would not be appropriate for the UK.

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