

**DEREK HIGGS' REVIEW OF THE ROLE AND EFFECTIVENESS
OF NON – EXECUTIVE DIRECTORS**

CBI RESPONSE

6 September 2002

INTRODUCTION TO AND STATEMENT OF CBI POSITION

1. The CBI welcomes the opportunity to respond to Mr Higgs' consultation document.
2. We set out in this Introduction and Summary the views of CBI members on the main issues relevant to this Review. This is followed by a summary of our principal recommendations in the light of these comments. We then set out our responses to the individual consultation questions.

Background

3. Following Enron and WorldCom, it is understandable if the confidence and trust rightly placed in the boards of directors of listed companies properly to exercise their legal and fiduciary responsibilities for the stewardship of the business has been tarnished. These corporate collapses occurred in the US, and under different, arguably inferior, legal, accounting and corporate governance systems now sought to be addressed in the US by the Sarbanes-Oxley Act. In the UK, we experienced our own sudden corporate collapses at the end of the 1980s, which led to the establishment of the Accounting Standards Board, much more rigorous accounting standards, and the Cadbury Committee's Code of Corporate Governance, since further developed by the Hampel Committee and the Combined Code. In addition, the UK has a principles, not rule based, approach to setting accounting standards, which the US will also now consider adopting. The UK therefore in many ways leads the world in its accounting standards and corporate governance systems.
4. However we are not complacent, and the CBI and its member companies are keen to support appropriate initiatives to maintain, and indeed to enhance, the standing and reputation of UK companies amongst both institutional investors and private individuals who invest through their savings and pension schemes. We therefore support the Government's initiatives on establishing the Co – ordinating Group to review auditing and accounting practices, and Mr Higgs' review of the role and effectiveness of non-executive directors.
5. While the US has recently acted with commendable resolution to put their house in order, the speed has left companies, particularly non-US companies, in some confusion over some of the detail.



Fundamental issues and objectives in considering reform

6. In order to conduct a review of the role and effectiveness of non-executive directors, one needs starts at first base with the board itself. The board of a company needs to comprise the best people to give strategic direction and contribute management skills and expertise to the business. It should be composed so that the best skills are available to make sure the company is well run and well directed, with integrity, so as to maximise value for shareholders. It is the chairman's role to ensure that an appropriate balanced board is in place.
7. One of the key roles of the board is to make sure that all the appropriate financial and other controls are in place and that risk is properly assessed. The board should be assisted in this by the audit committee, and some companies may also establish a risks committee. Boards may need to do more in explaining the main risks to which the company is exposed.
8. Investors buy equities in order to obtain a higher reward than is available from other types of investment. To obtain a higher reward, a higher element of risk must be undertaken. Equities can never be risk free, by their nature that cannot be so. Investors must understand that even the best management, with the highest integrity, cannot guarantee success and constantly increasing value.
9. Effective procedures need to be in place to ensure the proper governance of a company. However, such procedures cannot operate as an insurance policy against loss. If too much concentration is put on avoiding loss through over regulation, then entrepreneurial spirit, business development and innovation will be stifled. Where corporate failures and abuses involve fraud or other culpable conduct, even the most sophisticated regulation cannot protect completely against the fraudster.
10. Accordingly, recommendations coming out of this and other reviews should be aimed at the better and more efficient operation of companies, and towards greater productivity among companies, as well as towards heightening standards of integrity and governance.
11. Turning now to the position of non – executives themselves, we support the statements in Paragraphs 4.4, 4.5 and 4.6 of the Cadbury Report, and in Paragraph 3.8 of the Hampel Report referred to in Paragraph 14 of the consultation document on their key roles and responsibilities. They identify the role of non – executives in developing with the executive directors the board's key strategies and objectives for the business, in reviewing the performance of the executive management in their implementation, and in dealing with corporate governance issues and issues where there is or might be a conflict of interest. As noted in these paragraphs, what is fundamentally important is for the executive and non-executive directors to operate as an effective and cohesive team.
12. It is vitally important that people are encouraged to become non-executive directors. For this purpose their role needs to be clear, their responsibilities need to be clear, and the risk they undertake in accepting an appointment needs to be properly assessed. Particularly post Enron and WorldCom, there must be some discouragement from becoming a non-executive director, which needs to be reversed. NEDs should ensure that they have a clear understanding of the risks involved before accepting the position.

13. There is also a need for the major institutional shareholders in a company to take a more proactive interest in the company's business strategy and objectives, and progress in achieving them. This can be demonstrated by exercising votes at the AGM and other general meetings, but also through personal contact at senior level with the Chairman and CEO/CFO. Boards consider that currently that too many meetings with investors and analysts are with less senior staff or compliance officers who are mainly interested in assessing the prospects for the company's share price in the short term and whether to trade in the stock, or in limiting their interest to remuneration or other governance issues, and not the company's long term strategies and objectives.

Reform mechanisms

14. There are two main avenues to achieving reform – further legislation and updating the Combined Code.
15. Legislation has a role to play through implementation of the Company Law Review recommendations for modernising company law. This is now being taken forward by the Government in its recent White Paper. In this connection, and of particular relevance to Mr Higgs' review, we have supported the proposal for codification in statute of directors' general duties. We are studying the detailed provisions proposed in the White Paper, to which we will be responding in due course.
16. In areas of corporate governance, precedents are being set for addressing more issues in legislation, (as evidenced by the recent US Sarbanes-Oxley Act, and in the UK by the Directors' Remuneration Report Regulations and the proposal for a statutory Operating and Financial Review). However, we continue to believe that most corporate governance is best taken forward through regular updates of the Combined Code and accompanying guidance and recommendations, (including such as the existing guidance on the OFR and internal controls). This can be underpinned by company law and appropriate enforcement mechanisms where appropriate, as envisaged in the Company Law Review report. For example, the proposal for a statutory OFR has developed precisely because of the success of the existing voluntary arrangements for listed companies underpinned by the Combined Code and guidance from the Accounting Standards Board. Our concern for the statutory approach is not that the OFR itself is not a valuable tool for shareholders and investors, but that the statutory approach could result in sterile boilerplate statements. We do not wish this, and hope that a statutory OFR will indeed achieve the success intended.
17. We consider that the principal way forward is to continue to develop best practice recommendations and guidance and updating the Combined Code as appropriate. Whilst the Combined Code itself is concise, the Hampel Committee report of 1997, on which it is based, contains many useful recommendations and much guidance, which remain very much valid today. Mr Higgs' review can provide additional beneficial guidance, but combined with the recommendations coming from the Co-ordinating Group on auditing and accounting, there is probably scope for a formal updating of the Combined Code and accompanying recommendations. In addition to companies and boards, this should address further the position of auditors and institutional shareholders.
18. In summary, companies do not see a significant role for further legislation beyond that already contemplated. Companies wish to preserve the UK's unitary board system under which all directors are equally responsible for the management and stewardship of the business, (although individual liability may vary according to the particular facts), and do not support legislative intervention which would undermine it. Calls for distinguishing between the responsibilities of executive and non-executive directors would be more feasible in a two-tier board structure, which the current reform of UK company law could take forward, for those wishing to adopt this model.

Recommendations and guidance on best practice and updating the Combined Code

19. Accordingly, Mr Higgs' recommendations on best practice on the role and responsibilities of NEDs should extend to the board as a whole, for the benefit of all directors, shareholders and investors and in improving the understanding and knowledge of people generally. This was also envisaged in the Government's White Paper.
20. The guidance should set out the company law position of directors, covering directors' duties, including how such duties apply to the role and responsibilities of NEDs. The guidance could reiterate the statements on the roles of NEDs made in the Cadbury and Hampel reports referred to above.

Board committees

21. The recommendations and guidance should set out the role and responsibilities of board committees, the main ones being the audit, remuneration and nomination committees. These are still considered to be the main appropriate committees, but there could be guidance on the merits or desirability of possible additional board committees. For example, some companies, particularly banks and financial services companies, may wish to establish a risks committee. Another possibility is a finance committee to keep under review a company's borrowing funding and treasury arrangements. Larger companies may find it appropriate to establish additional committees. Ultimately, however, it must still be for individual boards to decide what board committees they wish to establish.
22. Notwithstanding the Directors' Remuneration Report Regulations and the US approach in the Sarbanes – Oxley Act, CBI members do not support a rigid and prescriptive statutory approach to boardroom responsibilities and those of board committees in the UK. Most CBI members still consider that they can be better addressed by means of the Combined Code and regular reviews and updating of it. This approach also seems to be that envisaged by Mr Higgs himself.

Audit committee

23. The Institute of Chartered Accountants in England and Wales (ICAEW) last year produced very helpful guidance on audit committees in its publication "The effective audit committee : a challenging role", which we commend.
24. The members of the audit committee and their terms of reference, should be provided in the annual report. The terms of reference will be set by the board as a whole, and they should be kept under regular review and brought to the attention of new members.
25. The Cadbury report provided specimen terms of reference, and the ICAEW publication has a further example. Ultimately the board as a whole should set them after full discussion, but we would support that the audit committee recommend the choice of the audit firm, approve their terms of engagement, and fees, and monitor and review their performance. On rotation of audit firm, we have looked seriously at the question of mandatory rotation at prescribed intervals. However, we believe that a better option is to encourage genuine consideration of the performance of the company auditors. The issue of rotation and choice of auditor must be a matter for the audit committee, which they should keep under regular review, taking into account the views of the executive management. Auditors are currently appointed or re-appointed each year, and the audit committee's recommendation, and an explanation of their decision as to whether to reappoint or to change the auditors, should be set out in the annual report, and in the AGM notice with the Resolution regarding the appointment of auditors
Such a statement could cover the relationship of the company with the auditors, the quality of service and value for money provided.

26. The audit committee should also keep under review the provision and extent of non-audit services by the audit firm to the company, as recommended by Hampel. The CBI is opposed to a complete ban on the provision of non-audit services because some services can be better provided by the auditors without the possibility of conflict. We agree that services should not be provided where there is a conflict of interest, but this would be better dealt with by auditors' professional rules rather than by legislation. Companies find certain services advantageous and cost effective, such as in respect of taxation advice or corporate finance work. There are already existing disclosure obligations regarding the respective fees paid to the audit firm for audit and non-audit services, and this could be extended to a broad or general description of the non-audit services carried out. This would enable shareholders to be better informed before the vote at the AGM.
27. Whether in respect of the audit itself, or the procurement of non-audit services, the company might wish to proceed by means of a formal tender, as is commonly the case in respect of any significant procurement requirement. The audit committee should have a role in overseeing the company's procurement process although not the actual procurement.
28. Clearly the audit firm should not audit its own work. Therefore there should be restrictions on the use of the audit firm to install core systems and on auditors carrying out internal audit functions, and in other areas such as those identified in the Sarbanes – Oxley Act. However such restrictions are still probably best dealt with by professional rules and guidelines which can spell out the rules in detail, and regularly review and update them as appropriate, more easily than by statutory regulation.
29. The audit committee should hold regular meetings with the auditors in the absence of the executive management. Such meetings would be expected to take place prior to publication of the full and half year financial results, to discuss issues arising out of the audit and how they should be addressed, and meetings at any other time as they judge appropriate. The auditors should have an established line of communication to the chairman of the committee to use as necessary. NEDs not on the audit committee should also be able to meet with the auditors separately from the executive management. **We believe that this would hugely empower the non-executive directors.**
30. In line with the Hampel recommendation, we also agree that companies, which do not have a separate internal audit function, should review the need for one at least annually. This should also fall within the remit of the audit committee.
31. The audit committee chairman should provide a statement in the annual report of the audit committee's activities during the financial year.

Remuneration committee

32. The role and responsibilities of the remuneration committee, although not technically prescribed by statute, will in practice be heavily controlled and influenced by the recent Directors' Remuneration Report Regulations.
33. We support full disclosure and transparency of Directors' Pay, and we share the legitimate concerns about rewards for failure.
34. On not rewarding failure, the difficulty is the termination of a contract entered into in different circumstances. However there is a strong argument for paying compensation monthly, like salary, rather than in a lump sum, with payments terminated or reduced in the event of new employment being obtained during the balance of the original contract period – and contracts now normally do not exceed one year.

Chairman's membership of board committees, particularly nomination committee

35. Recommendations and guidance should also address the position of the chairman, and membership of board committees.
36. A non-executive or part time chairman should not be precluded from membership of a board committee, but it may strengthen the independence of the committee's role, if the chairman of the board was not also chairman of the audit committee or remuneration committee. In many companies he will not be a member of these committees either.
37. However, it is normal for the company chairman to be a member of the nominations committee, and indeed be its chairman, since it is a key role of the company chairman to ensure a balanced and effective board with the appropriate mix of skills and experience necessary for that company.

NED meetings with shareholders, investors and analysts

38. As for separate meetings by the non-executive directors with those such as institutional investors and analysts, in the absence of the executive management, we do not see this as an area for good practice recommendations.
Companies are very concerned that such a proposal could cloud issues of accountability and communication. In many companies, the board will strongly consider that the CEO and / or the finance director should also be present. The CEO of many listed companies probably spends 10 – 12 days a year talking to investors.
39. We accept that it may be appropriate for the chairman to meet with senior representatives of institutional investors, with or without the CEO, as he judges appropriate. Meetings by the chairman with his senior institutional investors from time to time would be a normal part of a chairman's role, but beyond this it is really a voluntary matter how this is carried out, and there will clearly be close liaison between the chairman and CEO.
40. Non - executives can clearly assist the executive management when meeting investors in explaining the company's long term aims and strategy, and in demonstrating a cohesive and united board. The main annual occasion for this purpose is the AGM, but it is accepted that institutional investors prefer to communicate separately and in private. Boards do not have a problem with this.
41. A separate meeting between NEDs and shareholders may be appropriate if there is shareholder dissatisfaction with the performance of the chairman / CEO where the roles are combined, or in the case where there is dissatisfaction with both the chairman and the CEO. This is where the role of the senior NED identified in the annual report recommended by Hampel becomes key.
42. Other situations could be if a shareholder wished to discuss audit or remuneration issues, and a meeting involving the chairman of that board committee could well be appropriate. However we do not consider that prescriptive rules for such situations are necessary.
43. Regarding analysts, we cannot envisage situations where separate meetings between non – executives and analysts are ever likely to be appropriate as a matter of course, and therefore not appropriate for guidance.

Performance reviews

44. On reviews of the performance of the non-executive directors, this is already done in many companies, and is one of the roles of the chairman, who will seek non-attributable views of other board members and others, as he thinks fit. This review will include an assessment of the time commitment and attendance of the non-executive, and his other activities, including other board appointments, which may impinge. Again this could become a best practice recommendation. The chairman's own performance should be subject to review, perhaps led by the senior non-executive director in consultation with the other non-executives, other members of the board, and after other soundings as appropriate.

Number of NED positions

45. The CBI opposes any statutory or other restrictions on the number of non-executive positions an individual may hold. Clearly the individual must be able to have the time to make an effective contribution. What this means, however, will depend on the nature of other commitments rather than their number e.g. a business in crisis will take up more time than one doing well, a seat on a FTSE 100 company will normally be more demanding than one on a small family company etc. A person who is also an executive director may only have time for perhaps one other significant non-executive directorship. Therefore all the circumstances have to be taken into account, and a specific limit of say five positions would therefore not be appropriate. The time commitment and availability is primarily a matter for the individual concerned and for the board on which they sit, or is invited to join, and should be kept under review by the chairman as part of the performance review process discussed above.
46. Consideration could be given to guidance on the typical time commitment that would be expected of a NED depending on size and complexity of the business, and the specific NED role. However it may still be very difficult to come up with general guidelines because obviously so much is dictated by events and the individual company situation at any point in time.

Term of office

47. Currently NEDs are normally appointed for a renewable three-year term, which we support. However the independence of a NED, when held out as such, should be kept under review by the chairman and the board. As set out above, the NED's overall performance, including level of contribution, board attendance and other positions accepted, should be kept under review by the board before a decision is made on reappointment.

Unitary Board

48. In summary, all recommendations and guidance must be consistent with the UK's unitary board system, under which all directors, executive and non-executive, are jointly responsible for the management and stewardship of the business. As part of this, it must also be recognised that audit and other board committees are just that, namely committees of the board, and operating under the authority and terms of reference assigned to them. These arrangements clearly remain under continuous review by the board and by the chairman in particular. New NEDs, when invited to join the board, or to become chairman or a member of a board committee, should also look carefully at these terms before accepting.

CBI Recommendations:

Key Points for Good Practice guidance

- **Guidance for boards, shareholders and investors on role and responsibilities of board and board committees – mainly audit, remuneration and nomination committees - and the general and fiduciary duties of directors, both executive and non-executive, in line with the Company Law Review recommendations and Government White Paper.**
- **All this in context of maintenance and preservation of the UK's unitary board system under which all directors, executive and non-executive, are jointly responsible for the management and stewardship of company**
- **Executive directors and management should ensure that NEDs have full information**
- **NEDs should have regular separate meetings together**
- **If a NED resigns before the expiry of his term of office, he should give a reason in a letter to the chairman which should be circulated to all other board members**
- **Audit committee should have responsibility for recommending choice of auditor, terms of engagement and fees, monitoring their performance, approval of non audit services from the auditors including consideration of putting material services out to tender prior to decision to engage audit firm**
- **Audit committee should meet regularly with the auditors (such as prior to finalisation of full and half year figures) separately from the executive management**
- **As auditors should not audit their own work, professional rules should prohibit use of audit firm to install core systems, in providing an internal audit function, and generally in the areas identified in the US Sarbanes – Oxley Act.**
- **Where there is no internal audit function, audit committee should review at least once a year whether there is a need for one**
- **Audit committee chairman should report in the annual report on the activities of the audit committee during the year and answer any questions at the AGM**
- **Separate meetings between NEDs and institutional investors in absence of executive management should not be regarded as normal practice, but a matter for individual boards. They may be appropriate in a crisis, or regarding such matters as audit committee or remuneration issues**
- **Regular training and development of directors, and regular reviews of each director's performance, including NEDs**
- **The performance review would include review of the time and availability commitment of the NED in light of other appointments held, his chairmanship or membership of board committees, and his attendance record at board meetings**
- **Board and nomination committees should be encouraged to seek NEDs from senior management below board level in top 350 companies who can make a contribution, which will also provide career development and experience to the individual. Top 350 companies should be encouraged to co-operate in releasing such individuals.**

RESPONSE TO CONSULTATION QUESTIONS

SECTION A : ROLE

WHAT ROLE SHOULD NON-EXECUTIVE DIRECTORS PERFORM, AND HOW DOES THIS COMPARE TO THE PRESENT POSITION ?

Q.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?

Role of the Board

To set the company's strategy and business objectives in order to earn profits for the shareholders and monitor and steer the company's performance and success in pursuing such objectives.

To make sure that all the appropriate financial and other controls are in place and that risk is properly assessed (assisted by the audit and possibly risks committee; the board should decide which are the appropriate board committees to establish).

Role of the Chairman

- Lead and manage the business of the Board
Provide clear direction and focus
Maintain the integrity of the company by ensuring that board committees are properly structured and run, and that all corporate governance matters are fully addressed.
- Responsible for the composition of the Board, in particular to ensure that its capability is appropriate for the strategic and geographic positioning of the business (see also paragraphs 35-37 above)
- Ensure that the Board contributes fully in addressing and agreeing all major strategic issues and has sufficient information to monitor the performance of the business
- The Chairman must ensure that the strategies and actions agreed by the Board are effectively implemented by the CEO. The Chairman has principal responsibility for the overall performance of the CEO.
- The Chairman should ensure an effective relationship between the NEDs and the executive team, acting as the principal conduit for communications and issues relating to both business strategy and corporate governance.
- Develop a close and effective working relationship with the CEO, consult regularly with the CEO, and be available on a flexible basis to provide advice and support as required

The chairman's position is a crucial role. A good chairman ensures a good board. We do not support recommendations, which might marginalise the chairman's role. We believe that a non-executive chairman should be regarded as being as independent as a non-executive director. Therefore a non-executive chairman should not be excluded or disbarred from being a member of the remuneration and audit committees, but in larger boards he may prefer to have a right of attendance at meetings, rather than formally be a member. Clearly some different considerations will apply where the chairman is also the CEO, or a full time executive chairman.

Q.2. What should be the key roles of non-executive directors on the board and what should be the balance between the different components?

This is a matter for the board as a whole, but NEDs have particular contributions to make in the following areas:

- Contributing to development and agreement of board strategy and objectives for achieving a successful and profitable business for shareholders, through their experience, wisdom and advice
- Membership of board committees
- Monitoring performance
- Judging management effectiveness
- Through the Chairman, that the executive management is following and implementing the strategies agreed by the Board.
- Assessing internal controls and risk exposures, including through the audit committee (and risk committee common in banks and financial institutions)
- Custodians of the ethical behaviour of the Company to ensure the business is truly run in the interests of the stakeholders, particularly, the shareholders
- Compliance with the codes of corporate governance both in the UK and, where applicable, abroad
- That appropriate accounting policies have been adopted and are applied
- Responsibility for the auditor relationship
- Succession planning for the board

Within a board, should all non-executive directors be expected to fulfil each of the different roles?

NEDs have their duties as a director as with all members of the board. They will bring their knowledge, experience and judgement to board deliberations, as well as undertake specific roles, such as chairman or membership of a board committee. They will also bring their specialist experience and skills with a view to developing a cohesive team, able to be both advisers to, as well as monitors of, the executive management.

Members of board committees, in particular the audit committee, should have requisite experience and background to discharge their responsibilities properly, and a description of their CV and experience should be included in the annual report.

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

For most companies there should be little difference, because the roles already exist. They are as important today as ever, and should be taken even more seriously.

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

Independence is in the mind and depends entirely on the quality of the non-executive director. Someone can be “independent” in the sense of having no apparent conflicts by way of previous employment, family history, etc. and yet not be able to say “boo” to the proverbial goose. Another may have an outside interest, which may be a potential conflict, and yet speak out frankly. Therefore some of the existing definitions of independence are a distraction. It should be for the board, and the chairman in particular, to decide whether someone is independent. Independence is not something for which you can legislate. Any connections or circumstances, which could lead to potential conflicts of interest, should be stated; transparency and disclosure is everything.

Q.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 ?

The non-executive directors must stand up to the executive to protect the interests of the Company. The only sanction at the end of the day that the NED has is to resign.

It may be appropriate to include a provision in an updated Combined Code that when a NED resigns before his term is completed, they should give a reason by way of letter to the chairman copied to the rest of the board. The letter should be circulated at the next board meeting and properly minuted. Each director should always consider, if anything is done in the name of the Company, would they be happy for their conduct in these matters to be public knowledge and in the public domain.

Well known examples of conflicts of interest are executive remuneration, directors' interests (if any) in contracts with the company, management buy –out of the company or part of its business, substantial shareholders represented on the board.

Another area of potential conflict could be pressure on the executive management to meet the short-term earnings expectations of institutional shareholders and analysts.

Q.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 depends entirely on the size and complexity of the business. The number of positions anyone can take up depends on the time each person has available. For example, someone who has no executive commitments could obviously take on more roles. It is impossible to state a specific number. This is an issue to be considered by the Board when initially recruiting the individual. Each Board, and in particular the Chairman, should satisfy themselves by way of a performance / attendance review that the NED is spending enough time with the company to fulfil his duties.

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

The role of the “senior independent” is the position of last resort and should remain so. Essentially it exists in companies where the roles of chairman and chief executive are combined in the same person, but the role could be relevant if there is any dissatisfaction with the non-executive chairman. A deputy chairman could fulfil this role. The Combined Code provides guidance on the appointment of a senior non-executive director to fulfil these roles and we do not see the need to add to this.

Q.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?

Most CBI members strongly believe in a unitary Board, and support the view that all directors, whether executive or non-executive, should have the same responsibilities under company law, although the extent of individual liability may differ depending on the facts of the case, as determined by the courts. Any distinction between the legal responsibilities of executive and non-executive directors would create a de facto two tier Board.

We support the codification of the main general duties of directors, and we are studying the Government's proposals on this in its recent White Paper.

We also support the ability of companies and their shareholders to establish a two tier board structure if that is what they wish, and the Government should address this in its reform programme.

Concerns over the availability and terms of insurance cover is an issue, which may hamper the recruitment of NEDs, particularly in the light of the ever increasing responsibilities and profile now expected of them.

SECTION 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?

Q.9. What are the key skills, knowledge and experience which are needed by non-executive directors to perform 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?

This depends on the size and scale of the business but the critical requirements are:

- Financial literacy
- Commercial awareness and relevant previous experience
- Integrity and an open mind

Collectively there should be a balance of skills and wide ranging experience appropriate for the particular company and its objectives. What are needed are people who can contribute to the business and the generation of wealth, which is the prime purpose for the company's existence.

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

Honesty, integrity and independence and the ability and willingness to speak out. NEDs should be able to command the respect of the executive directors in order to operate effectively.

Q.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.

It is important to have a wide mixture of experience. Some corporate experience is helpful but not necessary. It is important that NEDs should have had experience of managing something and can therefore understand the pressures and requirements of managing an organisation whose size is similar to the one on whose Board they are a member. It is also important that individuals have relevant commercial knowledge; it is difficult to understand how anybody without financial experience can, for example, chair an audit committee.

One CBI member has commented that when it started to expand internationally, it was helpful to have as a NED someone whose business was global.

Q.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?

It has become more difficult as the liabilities of a NED become more apparent, and with the increasing difficulties in obtaining appropriate and affordable insurance cover. It is important that Boards try to recruit from as wide a spectrum as possible but to appoint to a plc somebody with no experience of working with or for a public company would be a mistake, unless that person had a particular skill pertinent to the Company. As already noted, nomination committees, and the recruitment consultants they may engage, should also be encouraged to go further down organisations to find talent.

When describing directors' backgrounds in the annual report, a description of the particular attributes and experience, which each NED brings to the Company, could be included.

Q.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?

There is a constraint on the recruitment of NEDs in that many nomination committees / recruitment consultants tend to require NEDs to have more Board experience.

The main concern for companies, however, should be to get people with experience relevant to the business who will understand the risks and opportunities. The experience need not necessarily be at board level but should be relevant. What companies need is someone with an interest in the company's operations with some knowledge of finance and a commercial approach.

As stated, the experience need not always be at board level in another company. Experience in running an organisation, not always another company or business, could be relevant. It is building a cohesive and effective team at board level with the necessary range of skills and experience relevant to the particular company that is the overall requirement and objective.

On widening the pool, the top 350 companies should encourage, and be prepared to release, senior people within the company below main board level to take on one non-executive director position. This would both benefit the smaller plc or company board they join, the individual concerned in developing their experience, and his main employer if the individual ultimately moves up to main board level or elsewhere in his organisation. In order to encourage this, the top 350 companies could disclose information on the number of people below board level holding a NED position. Peer pressure would then encourage the business to release such people to allow them to perform this role. Clearly large companies can expose senior managers with board positions in their major subsidiaries, but smaller plcs and other companies will welcome the influx of experience as well as exposing the individual to new organisations and cultures as part of their personal development.

One issue which we know from anecdotal evidence may discourage potential directors, especially US citizens, is the fact that directors' home addresses are still publicly available at Companies House. The provisions of the Criminal Justice and Police Act 2001, following the attacks and intimidation of directors in the Huntingdon Life Sciences case and other examples, have not been sufficient to allay these concerns which are limited to proof of risk of, or exposure to, violence and intimidation, by which time privacy of home address has been lost. There should be a general right of all directors to keep their home address details off the public record, and before any risks and exposure to violence and intimidation have arisen.

Q.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?

The reward should be for a mixture of experience, time and risk. Some CBI members favour payment in shares or a mixture of cash and shares. Share options and other forms of incentive related payments are not supported. Some also consider that NEDs should not look to their fees from that company as their main source of income as this would impair their independence. However, people retiring from full time employment are a good source of experienced NEDs and should not be discouraged.

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

Insurance is essential. However, many companies and directors are concerned that insurance is becoming significantly more expensive and less comprehensive, and that section 310 Companies Act 1985 is too restrictive.

This may well cause problems in attracting NEDs to serve on company boards, and companies and managements they are not familiar with, or companies experiencing trading or financial difficulties.

SECTION C : STRUCTURES AND ACCOUNTABILITY

DO EXISTING STRUCTURES AND PROCEDURES FACILITATE EFFECTIVE PERFORMANCE BY NON-EXECUTIVE DIRECTORS BY NON-EXECUTIVE DIRECTORS ?

As stated earlier, from time to time companies will fail. This can never be entirely prevented. There is a realistic limit to what can be expected from NEDs in the limited time available to them, particularly when the company is doing what the market wants.

One lesson perhaps to be learned from Marconi is the need for finance directors with strong hands-on operational experience in business.

Q.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?

The Combined Code has generally worked well, and in particular its disclosure and compliance and explanation for non-compliance approach.

Clearly the Combined Code must be kept under review, and there will be a need to update its guidance at intervals, and we have highlighted some possible instances in this response. See also our Key Points on page 9.

Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?

The Combined Code can provide guidance, but ultimately it is a matter for the Board and the individual director. A brief CV of the director will normally appear in the annual report, and through such disclosure, shareholders can form their own judgement on the suitability of the individual, and if appropriate take up any concerns with the company.

See also our comments in response to Question 4.

Q.17 Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors?

Yes.

Are board meeting procedures working effectively? Do you have comments on board size?

Procedures are generally working effectively. Boards should not be too small, nor too large. Whatever the actual size, which will vary from company to company according to their circumstances, it should not inhibit the effectiveness of the board, which is paramount.

Q.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?

We have discussed audit committees and suggested further guidance that might be issued in the Introduction (paragraphs 23-31) and Key Recommendations above.

Most audit committees see the audit relationship partner on their own after an audit meeting. This would be strengthened by meetings taking place separately from the audit committee meetings. This would hugely empower non-executive directors and would avoid any possible embarrassment should a NED wish to raise anything and, such meetings, if standard practice, would not cause the executive directors concern. The auditors should raise the top 5/10 issues arising out of the audit and discuss them with the audit committee.

Q.19 Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?

We have discussed Nomination Committees in response to Q.12 and in paragraph 37.

In future, the role of the Remuneration Committee will be heavily influenced by the requirements of the recent Directors' Remuneration Regulations 2002. We support transparent remuneration policies and for rewards to be linked to performance.

We share the legitimate concerns about rewards for failure. However, drafting contracts which actually deliver executive rewards linked to performance is extremely difficult. The role of the company secretary will be important here. There is a strong argument for paying compensation monthly, like salary, rather than in a lump sum, with payments terminated or reduced in the event of new employment being obtained during the balance of the original contract period – and contracts now normally do not exceed one year.

Q.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?

All directors including NEDs should be subject to an annual review. In respect of NEDs, this could be done by the chairman, after informal consultations and soundings as appropriate, and possibly with outside assistance if necessary. See also comments in paragraph 44.

Q.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?

The board's policy on performance review should be disclosed. Information on attendance levels could also be provided. Other important issues, however, are the length of appointment and the length of service.

It is the chairman's role to ensure the board is operating effectively. Any concerns of shareholders should be taken up with him, or if appropriate, the senior NED.

Q.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?

Ultimately this is a question of the independence of mind of the NED. Our suggestions above for a separate meeting of the audit committee, and of all NEDs if they so wish, with the auditors would greatly assist NEDs' awareness of potential problems.

The problem that NEDs have is that the only real sanction is to resign. Should a NED resign during his term of office, he should state the reason by way of letter to chairman copied to the rest of the board. This letter should then be minuted at the next board meeting. This would concentrate the minds of the executive management. However, you cannot have a dialogue going on between the NEDs and the shareholders as this would be divisive and could lead to selective disclosure of confidential information.

D: RELATIONSHIPS WITH SHAREHOLDERS AND OTHERS

DO EXISTING RELATIONSHIPS WITH SHAREHOLDERS OR OTHERS NEED TO BE STRENGTHENED ?

Q.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?

See our comments above in the Introduction (paragraphs 13, 38-43).

Q.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?

Most good companies do this. This is all part of the development of the effective NED, and also goes to the importance of encouraging the top 350 companies to release their senior managers below main board level to serve as a NED, discussed above.

Most chairmen will insist that NEDs (and the rest of the board) are supplied with full information and that papers and presentations to board meetings are well written / presented – see also response to Q 27.

Q.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?

Open, honest, independent. This should be true for all these relationships.

The key relationship may be with the chairman, as the chairman of the board, and leader of the team. The relationship with the CEO is also key, because the CEO is responsible for implementing strategy agreed by the board, including the NEDs. There is likely to be a lesser relationship with other members of senior management not on the board, unless an individual is attending a board meeting to make a presentation etc.

Relationships with key advisers will on the one hand reflect any specific roles, such as membership of the audit committee or remuneration committee involving meetings with auditors and remuneration advisers. See earlier comments in paragraph 29; the chairman of the audit committee should have an established line of communication to the auditors and the committee and NEDs should be able to meet separately with them. There may also be meetings in connection with specific matters being dealt with by the board in settling or implementing the company's strategy and business plan. All this is without prejudice to the right of NEDs to take separate counsel and advice whenever necessary or appropriate.

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

Company Secretaries do have a very important role. They could be considered to be the conscience of the Company and possibly their roles and powers within plcs could be strengthened.

In listed companies, they are often legally qualified, and often a Chartered Secretary, and therefore considered semi-independent because of their professional obligations as counsel. They can play an important role as gateway for non-executives to support functions within the company such as in-house legal and other professional advice.

The Company Secretary should ensure that all relevant and necessary information is sent to all directors, particularly the NEDs, and in conjunction with the board or committee chairman that all appropriate issues are considered at board and committee meetings, and that they receive appropriate advice from within the company or from outside advisers, including keeping the board up to date with company law and corporate governance developments.

E: SUPPORT

HOW CAN NON-EXECUTIVE DIRECTORS BEST BE SUPPORTED TO PERFORM THEIR ROLE?

Q.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?

Executives and management must ensure that NEDs have full information.

At the same time, any NED worth his salt will insist on enough information in a timely manner to be produced to give him a good view of the performance of the Company. Too much information can be as much of a problem as too little, creating overload or an inability to find the important issues. NEDs need summaries of the major issues.

How long and detailed these are will depend upon the complexity of the issue, and the importance and impact it could have on the company – such as whether it is a major policy or strategic issue or for a company in financial difficulties affecting its survival or a lesser issue or item for information.

The preparation and presentation of papers for board meetings is a key skill and companies should provide where appropriate presentation and communication training for those preparing papers or making such presentations.

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

There are training schemes available at management schools and they could be improved. The Institute of Directors has also launched a Chartered Director qualification. However a formal qualification should not be mandatory.

Training for new directors could include role-playing board meetings, preparation and presentation of board papers, covering key and controversial issues, and covering the roles of both executive and non – executive directors.

For a particular NED, in order to be suitable, they should already possess many of the core skills and requirements the company seeks.

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

As a matter of best practice, NEDs should have a proper induction process. Prior to appointment, as well as meeting the board and other NED, a NED should meet with the auditors. It is in the best interests of the NED to do this since prior to joining a Board he should be absolutely confident that controls are in place, the company is well run, and that the profitability of the business has not been stretched or misstated.

Q.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?

This should be covered on recruitment and appointment and by an annual review, or at any time it becomes appropriate.

F: SMALLER LISTED COMPANIES

IN WHAT WAYS IS THE POSITION DIFFERENT FOR SMALLER LISTED COMPANIES ?

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

The role of the NED varies enormously from the FTSE100 company to (when they are present at all) the private company.

In smaller entrepreneurial companies, where the directors may have a substantial or controlling interest, there is even greater emphasis on the NED's potential contribution to the growth and business strategy of the company.

The typical role of the NED in a smaller listed company lies somewhere in the middle. Such companies are, or should be, primarily focussed on business growth.

The appointment of NEDs needs to reflect this. What is appropriate experience will vary from company to company.

In selecting NEDs, biotech companies may wish to appoint a scientist, IT companies may wish to appoint directors with relevant technological expertise; other companies may want directors who can advise them on expanding into overseas markets.

Such directors need not, and often will not, be experts in accounting or corporate governance, or have previous board experience. At the same time, such experience can be helpful and NEDs to smaller companies who have experience of larger companies will often spend more time mentoring the executive directors there. To impose the same NED rules on smaller companies as are applied to large companies, however, would merely result in the appointment of inappropriate NEDs.

By recruiting NEDs from a much wider range of backgrounds than might be appropriate in large companies, the potential pool of experienced NEDs is increased and diversified. A proportion of them will become suitable for appointment to the boards of larger listed companies, thereby improving the available pool at that level too.

G: INTERNATIONAL CONTEXT

WHAT CAN WE LEARN FROM INTERNATIONAL EXPERIENCE ?

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

The UK has some of the best corporate governance in the world but no doubt it can be improved, and we have made some suggestions in this response, including the Recommendations on page 9.

The US style CEO dominant paradigm is generally regarded as not the best corporate model for major listed companies. Good governance is based on balanced boards led by a strong chairman and a strong independent element.

Independence of the auditors is also key.

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

No.

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

We consider that international practice is moving towards the UK model. Certainly the US model does not seem to have worked adequately and many of the recent changes have been to enable them to “catch up” with the UK model.

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