

Response of CIS

Review of the role and effectiveness of non-executive directors

A: Role

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

Question 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 Chairman is set out below:

- Normal duties of chairing meetings
- Ensuring that board collectively possesses necessary skills, knowledge and experience to direct the company
- Ensuring that the NEDs are of sufficient calibre and independence effectively to scrutinise the executives
- Ensuring adequacy of reporting to the full board
- Determining composition of key board committees
- The Chairman should be the focal point of concerns for other NEDs
- Promote standards of governance throughout the company

In CIS's view, these functions can best be discharged by a Chairman independent of management.

Question 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 key roles of the Non Executive Directors (NEDs) are:

- Reviewing strategy
- Reviewing performance
- Reviewing external reporting and providing a reality check on it
- Acting as a sounding board to management initiatives
- Bringing shareholder concerns to the attention of the board
- Acting as members of key board committees

There needs to be a balance between all these functions, the principle roles being reviewing strategy and performance against that strategy.

It is not for each individual NED to execute all these functions, but collectively the NEDs must be able to discharge them.

Question 3: *How does this compare to the present position?*

At present there is no defined role for a NED.

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

- The Audit and Remuneration Committees should be composed solely of directors of independent connection.
- The Chairman should ensure that the discharge of other NED functions should be by NEDs, a majority of whom are of independent connection.
- The Chairman should satisfy himself that all NEDs demonstrate independence of judgement.

Question 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?*

- Executive Remuneration – there are 2 issues: fixing of remuneration performance targets and ensuring that corporate priorities are not skewed in order to meet performance targets
- Where a company is approached for a merger, to make sure that Executives Directors do not reject the bid to protect their own positions or, conversely, accept the bid for the immediate personal benefit. The NEDs need to see the overall merit of a proposed merger in terms of the interest of the Shareholder and of the company as a whole.

Question 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?*

It is not helpful to be completely prescriptive, but we would suggest the following as guidelines:

- 30 days a year for a Chairman and 20 days for ordinary NEDs per company.
- Number of roles: maximum of 4 for NEDs with an executive position elsewhere
- Limit directorships to about 3 or 4.
- NEDs directorships should be disclosed in the information on directors in the annual report and accounts.

(It should be noted of course - that larger and more complex companies will involve a greater commitment.)

Question 7: *Should there be a special role for a "senior independent" non-executive director?*

In practice, this position has been of little relevance; an independent chairman would obviate the need for one. CIS consider, however, that a SID should be nominated where there is an Executive Chairman.

Question 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?*

CIS advocates the introduction of a statutory statement of directors' duties that distinguishes between Executive Directors and NEDs, in terms of both their responsibilities and potential liabilities.

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?

Question 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?*

Collectively NEDs should possess:

- Accounting knowledge
- Industry expertise
- Board level experience or equivalent.
- Knowledge of corporate governance standards

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

- Independence of mind and judgement
- Integrity
- Resilience
- Confidence
- Eye for detail

Question 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?*

No comment

Question 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?*

Companies are increasingly experiencing recruitment problems. Anecdotally, the perception of increased exposure to personal liability is the most significant factor.

Question 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?*

- As a corollary of expecting people to limit the number of executive posts, fees should be increased, although never to a point at which a NED becomes dependent on that directorship as a main source of income.
- Correct balance between responsibility and indemnity.
- Increase protection: it is wholly unreasonable for NEDs to be exposed to the same degree of liability as executive directors given the imbalance in available resources and detailed operational knowledge available to executives and NEDs.
- Consider people with boardroom experience who are not necessarily directors: for example, company secretaries and board consultants.

Question 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?*

- Rewards should be either in cash or in shares.
- Options are not appropriate for NEDs since NEDs should not be tempted to focus on short term share price fluctuations.
- Current pay levels: by themselves, they are not a significant factor, and we would not wish it to be such that they would affect independence; the real issue is the scale of the mismatch of the rewards they receive and the potential liabilities to which they are exposed.

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

- see comments above (question 13 and 14)
- Along with other companies, CIS has experienced significant difficulties purchasing directors and officers liabilities insurance for cover even at a basic level and there has been a substantial increase in exclusions and excesses.

C: Structures and accountability

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

Question 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?*

- CIS undertook research on compliance with the Combined Code for FTSE 100 companies and attach a copy for reference. The statistics illustrate that there are still many companies that fall short of full compliance, especially regarding the composition of their key board committees, particularly the remuneration committee.
- There is a perceived focus on compliance with code provisions rather than the underlying principles.
- Independence is notoriously difficult to define objectively. However, existing guidelines on independence of connection are published by ABI and NAPF, which are helpful and could usefully be incorporated within the Combined Code. It would be useful for shareholders to hold formal meetings with the NEDs to enable them to assess the overall performance and independence of judgement of the NEDs.

Question 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 virtually impossible for an outsider to assess the inner workings of a board committee. It would be helpful for companies to report that proper procedures are followed, for example, that executive directors whilst not strictly 'present' at committee meetings are not in the meeting as observers.

Question 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?*

It is our view that Audit Committees should be made up entirely of independent NEDs. We also consider that the entire process for the recommendation to shareholders of the appointment of auditors and determination of their terms of engagement should belong to the Audit Committee, rather than to the full board.

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

We are concerned that the requirement to appoint independent directors only to Remuneration Committees (RemComs) is honoured in the breach (see attached research). We are concerned that the inexorable upward pressure on the scale of executive remuneration continues without corresponding increases in performance targets, a situation that suggests the ineffectiveness of RemComs. We would suggest that RemComs be solely responsible for the selection and briefing of remuneration consultants. RemComs should be concerned primarily with rewarding executives on the basis of increases in the intrinsic value of the company rather than ratcheting up pay scales by reference to other companies.

Nomination Committees: the Chairman of the RemCom should be on the Nomination Committee and should ensure that the RemCom's agreed remuneration policy is applied equally to new appointments.

Question 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?*

Whilst we are aware of a number of organisations such as ICSA offering board evaluation services, we are not aware of actual instances of their use. Given that best practice is yet to emerge in this area, it would be premature to make any prescriptive recommendations.

Question 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 nonexecutive directors?*

The problem is determining who would provide information on the performance of the NEDs. The Chairman? But he himself is an NED. The Executive Directors? But this would be divisive and create a conflict of interest. The Company should report on its overall performance against its corporate targets. If such targets are not met, or are insufficiently challenging, it is for shareholders to challenge both Executive Directors and NEDs on the corporate failings.

Question 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?*

We are aware of instances where NEDs have successfully challenged executive directors' decisions. It is practice in some companies for full board meetings to be preceded by a meeting of the NEDs. If this were more widely followed, it could result in a strengthening of the position of the NEDs.

D: Relationships with shareholders and others

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

Question 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?*

Generally there is very little contact between shareholders and NEDs and there is widespread reluctance amongst companies to facilitate such contact. CIS would favour an annual forum between NEDs and institutional shareholders to enable dialogue and reinforce the bond between NEDs and the owners of the company, whose interests they represent.

Question 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?*

In discussions with directors, common complaints have been on the timeliness of board papers received and on overloaded agendas and over-detailed reports. In particular, it is a common complaint that too much time in the board is given to compliance in areas such as health and safety, which whilst acknowledged as important, are not seen as the most appropriate use of board time.

An independent non-executive chairman generally will have a more direct interest in ensuring the effectiveness of the NEDs.

Question 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 Chief Executive? What should their relationship be with key advisers to the Company?*

The NEDs should always be willing to act as a sounding board for the executive directors. In particular, committee chairmen should establish regular contact outside the board and committee meetings with executive counterparts (audit committee chairman with the finance director; remuneration committee chairman with the HR director).

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

All NEDs should have free access to the advice and resources of the company secretary, and should be able to circulate papers through the secretary to other board members.

E: Support

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

Question 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?*

NEDs should have access to as much information from management as they feel they require and should demand additional information where they believe it to be necessary. As noted above, information overload is often considered more of a problem and it is the duty of the chairman to ensure that reporting is sufficiently focused. We have not discerned a general feeling that managements withhold information from NEDs.

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

There is increasing provision of training opportunities, such as that provided by the Institute of Directors. It would be of interest to shareholders for companies to report on what training has been offered to NEDs and what the take-up has been.

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

Anecdotal evidence suggests that induction is variable and often fairly informal. It would be useful for companies to disclose what their induction procedures are.

Question 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?*

No Comment.

F: Smaller listed companies

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

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

CIS considers that in many cases the benefit of independent directors with a broader industry view can be especially beneficial to smaller and newer companies. The Combined Code is reasonably flexible and institutional investors are generally sympathetic to the difficulties in recruitment that smaller companies sometimes face. Flexible and sympathetic application of the Code is a better approach than lowering standards.

G: International context

What can we learn from international experience?

Question 32 *What lessons can be learned from international experience, either in terms of structures or behaviours?*

Corporate disasters in the US have occurred at companies with boards comprising a majority of independent directors, which underlines the suspicions of commentators such as Buffett that, more often than not, droves of such "independent" NEDs are in reality supine and often kept in the dark by executive counterparts. This highlights the need for genuine independence of quality NEDs: overloading boards with NEDs can be counterproductive. The failure to implement corporate governance reforms in Europe does not commend the two-tier board approach. The Japanese-style board, over-sized and packed with insiders is no role model.

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

See Above.

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

No. Overall the balanced-board approach in the UK as enshrined in the Combined Code, is considered the best approach for UK companies.

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