

**Review of the role and effectiveness
of non-executive directors**

Consultation Paper

**On behalf
Friends of the Earth, Amnesty UK and
New Economics Foundation**

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Introduction

Enron and other recent corporate financial scandals have focussed the spotlight on the role of those responsible for monitoring the very people running the company – principally the auditors and non-executive directors. However there is also a growing public concern over company's wider social and environmental impacts, such as genetically modified food and access to medicines in developing countries which also require closer scrutiny and reform of the role of non executive directors.

We welcome this review and the opportunity to comment on the role of non executive directors in terms of ensuring companies are run for the benefit of all interested stakeholders.

Codes of Practice versus Legislation

We note the Governments support for the use of voluntary codes of practice in preference to legislation and regulation. Whilst we recognise the benefits of codes of best practice such as the Combined Code on Corporate Governance they do not adequately address the seriousness of the role and responsibilities of non executive directors. There fore we believe that the Government should ensure the necessary supportive legislation and regulation is put in place to provide confidence for both investors and the wider community.

Key questions

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

Non-executive directors should be responsible for both corporate governance, particularly in scrutinising the performance and integrity of company directors, and in bringing a broad range of experience and expertise to the company board.

In relation to the former there is a clear need to ensure that non-executive directors are sufficiently independent and experienced to be able to properly scrutinise the chairman, CEO and fellow executive board members.

In relation to the latter there is a clear need to ensure a much wider diversity of non-executive directors to enable the views and experience from a wider range of stakeholders is heard inside the board room.

The pressure on non-executive directors to consider the wider impacts of a company's business including its ethical, social and environmental impacts comes not just from NGOs and socially responsible investors but also as a result of changes in legislation and regulation.

Two recent changes include amendments to the Pensions Act requiring pension funds to disclose any ethical, social and environmental factors in their investment strategies and the increasing emphasis on disclosure of environmental and social impacts as part of the proposed Operating and Financial Review (OFR).

In relation to the proposed list of statutory duties for directors as in the new company's bill it falls well short of what we consider acceptable for companies operating in the 21st century.

We note the failure to make consideration of social and environmental matters mandatory which fails to recognise the increasing importance of the role companies need to play in driving sustainable development and the increasing demand for such information from institutional investors, particularly those involved in socially responsible investment.

We believe that non executive directors should be bound by the same legal duties as executive directors while recognising the need to reform director's duties to include the consideration of social and environmental impacts.

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

In terms of building companies that are capable of operating in the 21st century we would expect a significant drive to recruit non-executive directors with experience of dealing successfully with sustainable development, poverty alleviation and human rights.

Many companies are guilty of recruiting non executive directors who reflect similar views of their own and who do not reflect wider public concerns about corporate behaviour. This works against companies who claim to be more responsive for their social and environmental concerns of their business as their directors lack the training, experience and competence to make such judgements.

Companies should be far more proactive in recruiting a more representative group of non executive directors who reflect a broader range of values and experiences, particularly in areas of human rights, poverty alleviation and sustainability. To do this company's could target individuals from outside traditional business circles including relevant public authorities and NGOs.

A clear lesson from the recent corporate scandals is the importance of ensuring that non-executive directors are independent and to have no conflicts of interest, whether real or perceived. This will require the recruitment of such directors to be as transparent and open as possible so that any conflicts can be easily identified and dealt with in manner that provides confidence to all stakeholders.

We strongly disagree with use of narrow minded short term financial incentives to recruit non executive directors such as substantial pay offers or share options. These type of incentives promote a lowest common denominator approach which puts short term profit above all else and we believe encourages unethical corporate behaviour such as promoting excessive executive pay increases and dismissing the companies social and environmental impacts.

C. Do existing structures and procedures facilitate effective procedure effective performance by non-executive directors?

What is clear is that traditional corporate governance structures and procedures need to be updated in light of recent corporate scandals and to reflect the demands for companies to be socially responsible.

The Combined Code of Corporate Governance needs to reflect much more clearly and explicitly how companies can take into account the significant environmental, political and social risks facing their business as was initially identified by Turnbull report. However the Combined Code alone will not deliver the necessary reforms required for good corporate governance and socially responsible behaviour.

As identified in the response to question A above non executive directors will need to come from a much broader base that is reflective of society's expectations of what companies are responsible for. There will to be need to transparent procedures in place for hiring of non executive directors with fixed term contracts and clear rules for extending them if necessary.

In relation to the role of board committees they should be expanded to consider the wider impacts of their business beyond profit such as addressing a company's significant social, ethical and environmental impacts. In terms of the make up of key committees such as for audits, ethics, remuneration and nomination of board members the committees should be entirely made up of non-executive directors.

The appointment of auditors for both financial and non financial reports, including environmental and social reports, should be determined by non executive directors.

To enable non executive directors to operate effectively and without fear of reprisal they should make up at least half the board and any appointed committee. They should be given the resources and access to relevant information they need to do their job effectively. They should also be allowed to question key personnel when performing their duties.

These measures above will hopefully encourage more 'whistle blowing' and help expose unwanted ethical practices by directors.

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

This is a critical challenge for companies who wish to be successful in the 21st century to move from a traditional narrow focus on shareholders to a much more inclusive approach which deals with all relevant stakeholders.

We see the selection of non executive directors from a much wider group outside traditional business circles as vital to ensuring such that companies more accurately reflect the needs of their stakeholders (see B above) as well as ensuring they are socially responsible.

In terms of credibility and accountability non executive directors with the experience in relevant social and environmental issues should be more closely scrutinising these aspects of the company and ensuring the relevant company policies and practices are in keeping with both the companies and stakeholders expectations.

E. How can non-executive director's best be supported to perform their roles?

Clearly non executive directors will need regular training in key social and environmental areas to be able to be effective in ensuring companies properly consider and take into account such matters.

There should be a strong emphasis on addressing social and environmental risks from the moment of induction so as to create and maintain a culture of 'social responsibility' within the company.

Non executive directors should be regularly briefed and kept updated on the issues they are responsible as well as undertaking active engagement with stakeholders on key and emerging environmental and social issues.