

Section 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?

1.1 The board has ultimate responsibility for the governance of a company. The role of the board (non-executives and executives directors alike) is to provide general direction to the company and to represent and safeguard the interests of the shareholders. In its work the board should also take account of the interests of the employees, creditors and other stakeholders.

1.2 The board, inter-alia, should:

- set the company's objectives and its strategy;
- ensure that the company has business plans to achieve the objectives;
- ensure that the company has a good executive team that is properly remunerated and motivated to achieve the objectives, strategy and business plans;
- ensure that the company conforms with best practice in corporate governance and business methods, and that its performance against objectives is reviewed on a regular basis, taking appropriate action where necessary; and
- communicate clearly and regularly to, and with, the shareholders.

The Chairman

1.3 The Chairman's role is to provide leadership and focus to the board and to ensure that the Chief Executive provides leadership to the management team. The Chairman should use the non-executives as his external sounding board. He/she should have the right to sit on all the 'key' board committees and he/she should set and maintain standards for the performance of the board. Additional information on the role of the Chairman is provided in Appendix C.

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?

2.1 The key roles of the non-executives are well described in the Cadbury and Hampel reports. By not being involved in the day-to-day management of the business, non-executive directors bring an independent and objective view to the boardroom.

2.2 Non-executive directors can act as:

- mentors to the executives (drawing on experience);
- advisers (drawing on business/industry knowledge and corporate expertise);
- supporters/alliance makers (bringing in contacts from outside); and
- challengers (acting to prevent willing acceptance of the status quo or 'group-think').

2.3 The roles played by a non-executive director will, in part, depend on their individual technical skills, such as marketing, finance, production, HR, etc., which should

complement or supplement those of the executives. Some non-executives may tend more to an advisory role and others more towards a monitoring role. Although each individual non-executive director is hand picked for his/her skills, using their collective and various individual skills, they should act as a team as part of the unitary board.

- 2.4 It is unreasonable to expect all of the non-executive directors to fulfil each role and the balance will depend on the individual company. They should not, however, attempt to perform these roles as a quasi-executive. Particular skills and attributes needed (which may change over time) are covered in Question 9 and Appendix C.
- 2.5 Boards will need to carefully define the competencies of their existing directors and what they are looking for in new board members. Boards must have suitably experienced and insightful individuals of integrity who are able to contribute to board level discussions, ask challenging questions and to help to create a sustainable and competitive advantage for the company.
- 3. How does this compare to the present position?**
- 3.1 Many well run companies have already have dealt with these issues, although further thought may be given to some reviewing and updating. Less well run companies, especially the larger listed companies, will have to look to the standards achieved by the well-run companies.
- 4. How independent do non-executive directors need to be for the different roles?**
- 4.1 The remuneration and audit committees should be composed of independent directors. With no conflicts of interest and the ability to ask difficult questions and say unpopular things, they can insist that their views are heard by the Chairman, the board and the shareholders.
- 4.2 All directors (non-executive and executive) should be ‘independent of mind’ to fulfil their duties. Independence of mind, being able to understand and deal with conflicts of interest, depends entirely on the quality of the individual. However, experience shows that some executive directors can find it difficult to be independent. Any actual or potential conflicts of interest must be disclosed.
- 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?**
- 5.1 The main issues of potential conflicts of interest are most likely to have their origin in issues related to meeting short-term expectations or other expectations of the market, such as revenue, EBITDA or earnings targets which then trigger incentivisation payments and/or share options to executive and senior management. Other expectations include the value of longer term investment projects/expenditure. Other areas of conflict include circumstances where a director has an interest in a contract or a relationship with a supplier or customer, or a personal agenda to pursue.
- 5.2 In addition to the board Chairman, the remuneration committee should play a part in

conflict resolution by helping to ensure that executive management's compensation packages are not heavily geared towards options or share grants that could encourage them to take short-term decisions to artificially increase the share price. The non-executives can help focus attention on longer-term sustainable growth, taking a dispassionate view, maintaining a focus on what is good for the company, the shareholders and the stakeholders, even if it is not good personally for the executive directors in the shorter term.

- 5.3 To assist non-executive directors, they should be able to take independent advice at the company's expense. Beyond this, other than to ensure that they cannot be sacked for speaking their minds, their only sanction is to resign. In paragraph 22.4, we suggest that to help a resigning director expose problems, consideration could be given, via legislation or regulation, to a requirement that he/she would have to provide written information that would be publicly available as the reasons for his/her resignation during the period of his/her period of office. There are, however, ramifications that need to be carefully considered.

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?

- 6.1 Time commitments will vary enormously and depend on the size and complexity of the business and the circumstances of the company. If a company is not in good financial health then more time will be required.
- 6.2 Time input is also likely to be affected by the professional background and experience of a non-executive director. If, for example, the non-executive director has a financial background, he/she is very much more likely to be drawn into issues than if they have (say) a marketing background. This is especially true in a financial crisis.
- 6.3 Chairmen have to devote considerable time to the business, which may average out to several days a week. Indeed, for a significant company they can be full time in their role but part-time in their involvement. The minimum time input for a non-executive is also impossible to answer, although it is likely to increase as a result of additional duties and committees.
- 6.4 The limit to the number of non-executive posts obviously depends on the demands of each company and the total time available to the individual. For example, for someone with a full-time executive role, it is perhaps difficult to envisage more than two posts. A practical constraint becomes the availability of days at a certain time in each month to read papers and attend board meetings. There should, however, be no prescription by legislation or regulation on the number of posts an individual may have.
- 6.5 Procedures in some companies may require to be more rigorous in this area. Annually the Chairman should review with each non-executive their time commitment and satisfy himself/herself that each individual is spending sufficient time with the company to properly fulfil his/her duties. Nomination committees should specify the time required and ensure that the potential appointee is not over committed.

6.6 There may need to be additional safeguards for a company if one of its non-executive directors is approached to take up a non-executive director post with another company. If, for example, a non-executive director of Company A is approached by the board of Company B to become a non-executive director with Company B, we suggest that not only will the nomination committee and the Chairman of Company B have to be satisfied that the potential appointee has the time available, but also that the non-executive director notifies the nomination committee and Chairman of Company A and obtains their agreement before accepting any new appointment.

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

7.1 Yes. The senior independent non-executive director (SID) is a focal point for investors to turn to when, for instance, there may be a lack of confidence in the Chairman. The role of the SID:

- (a) provides an avenue for institutional shareholders of quoted companies both to obtain an independent view and to raise concerns;
- (b) is important if there is a combination of the role of chairman and chief executive;
- (c) is relevant if there is a problem with the current non-executive Chairman or there is a need for a useful to counter balance a powerful Chairman; and
- (d) can help in assessing the capabilities and conduct of the CEO and to conduct an annual appraisal of the Chairman.

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?

8.1 Any attempt to distinguish the statutory duties of executives and non-executive directors would be very difficult and might undermine the unitary board concept. We support the view of the Company Law Review that does not seek to distinguish between the legal duties of executive and non-executive directors.

8.2 Whilst we appreciate that director liability is a very complex area, as part of the review of the Companies Bill, consideration should be given to the development of some basis for protection on liability matters. Consideration might be given to proportional liability and capping liability by way of contract, whilst ensuring that this does not also undermine the unitary board concept. This would apply to all directors and, in particular for the non-executive directors, be linked to what an individual would reasonably be expected to know. It needs to be recognised that the non-executive director can never be as knowledgeable about a company as an executive director. Non-executive directors have to, and are entitled to, rely (after due and careful enquiry) on the information provided to them by executive and senior management and other advisors.

8.3 The advantage of proportional liability (over the current joint and several liability) is that the quantum assigned to individual directors (and in particular the non-executives) is reduced and they are not expected to contribute to the losses awarded against rogue CEOs.

8.4 The billion pound litigation against all the former directors of Equitable Life indicates

that the current system of joint and several liability will increasingly become an impediment to selecting and retaining the best individuals.

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?

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?**
- 9.1 In an ideal world, the key qualities for a non-executive director are those derived from actual experience as a non-executive, which are different from those obtained as a member of the executive management team or from other roles in life. This would however perpetuate the status quo. Unfortunately, unlike management, it is impossible to learn from the bottom. So first hand experience of running an organisation (or a major function within an organisation), or those who have relevant professional qualifications combined with experience of advising companies at boardroom level are good starting points. There are also other sources of non-executive directors and we refer to these in Question 13.
- 9.2 All non-executive directors individually must have high ethical standards and integrity, commercial acumen, basic financial literacy and an understanding of the business of the company. They should also have a good understanding of the process of communication with shareholders and other parties outside of the company, including financial reporting, as well as the requirements of corporate governance and a good grasp of the principles of risk management.
- 9.3 Non-executives need to be detached and objective, probing and challenging, diplomatic whilst fearless in expressing their own opinions. By virtue of their experience and personality, non-executive directors should be able to stand up to the toughest and most persuasive colleague. Further information is given in Appendix C.
- 9.4 Whilst not every individual will need to have every skill (and requirements will change over time), collectively there should be a balance of skills and wide ranging experience across the non-executive directors to get different ideas and challenges to ‘group thinking’. Between them they should also have knowledge of the industry, of the geographical areas in which company operates and of the ways of the City.
- 9.5 However, even those boards that comprise vigorously independent non-executive directors may well prove ineffective unless such directors have both access to, and an understanding of, all the relevant information. Information is vital to the non-executive director (see Question 27).

Skills of a Chairman

- 9.6 A Chairman should possess the skills described above and in Appendix C. He/she will

also need some knowledge of human behaviour and ability both to support and encourage so that all board functions and roles are carried out and that he/she optimises the contributions of all directors in the decision-making process.

- 9.7 Chairing a board committee such as the audit or remuneration committee will require some specialist knowledge. For the audit committee, the Chairman should have a financial, preferably accounting, background. A human resources background is ideally useful for remuneration committee purposes.

Next 10 years

- 9.8 The next decade is not easy to predict. It is likely that there will be more regulation and boards and management will, most likely, need to prove integrity more clearly and to be both more rigorous and creative to ensure competitive advantage. This may mean better and faster decision-making and greater flexibility to be able to deal with the unexpected. The quality of communications will also be important.
- 9.9 On an individual basis, the development of corporate governance expertise will become more necessary over the next decade. Other skills that may come to the fore in future years include an increase in competency in risk management processes, skills related to reporting on social/environmental issues, as well as skills in IT and e-commerce.

10. What personal qualities and attributes are needed?

- 10.1 Overall, the non-executive directors need to operate as part of a team in the interests of shareholders and the company (taking account of the interests of stakeholders). They should not act out of personal interest. They need to balance the requirements of being involved at the strategic level with those of a monitoring role, whilst ensuring that they do not try to do the executives' jobs. Additional information on the personal qualities and key attributes of a non-executive director is given in Appendix C.

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.

- 11.1 The description of the overall framework and qualities in Questions 9 and 10 describe the mix necessary for a board.
- 11.2 The balance and emphasis of skills should be in line with the current and future business needs of the company. It is important to have a wide mix of experience and attributes. Non-executive directors should have had experience of management and be able to understand the pressures and requirements of managing an organisation whose size is similar to the one on whose board he/she is a member.
- 11.3 Otherwise the mix of experience and attributes depends on the company. Relevant industry experience (albeit which may be not current due to competitive pressures) can be helpful, mixed with the inclusion of people from a different sector/industry background who can suggest different ways of doing things. A variety of industry

backgrounds are ideal. For those on the boards of a company in a regulated industry (such as banking or insurance), an understanding of the regulatory environment is essential.

11.4 Non-executives can help spread best practice both from and to their own organisations. This should be one good reason for companies to encourage their own executives to take non-executive roles. For smaller listed and unlisted companies, specific experience of larger companies can assist greatly.

11.5 Examples where we believe that non-executive directors have contributed are given in Appendix C.

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?

12.1 Historically it has not been that difficult for large FTSE companies to recruit people, many have come from other quoted companies. Today it is getting harder to recruit the best people with the requisite experience. Recent events and, in particular, the writs against the former board of Equitable Life have highlighted the potential liabilities of non-executive directors. The risk/reward balance is now a major issue (see Question 14).

12.2 The Combined Code has it about right as far as the use of nomination committees is concerned, albeit consideration might be given to greater transparency and disclosure about the selection process and criteria used for the selection of directors.

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?

13.1 Boards, we understand, are wary of recruiting individuals who do not have the skills and practical management experience. Boards need to have suitably experienced individuals who are able to contribute to board level discussions and decisions and to help to create a sustainable and competitive advantage for the company. If individuals are unable so to do, then they should not be on the board.

13.2 The recruitment of non-executive directors solely from the pool of retired senior executives is not recommended. A mixture of ages and experience can bring additional benefits to a board along with the wisdom of age.

Backgrounds outside listed company boards

13.3 Boards should recruit using open and transparent appointment criteria to find those who are best qualified for the job. Consideration of potential non-executive director candidates may, include representatives from backgrounds outside listed company boards. Such backgrounds include people from the accountancy and legal professions and the financial sector (e.g. fund managers, corporate finance and banking). Top people from government, the not-for-profit sector, and academia may also produce valuable candidates who can translate their management and other skills into a

commercial environment and be able to make an effective contribution at board level. Appropriate training courses may be helpful here.

Individuals below board level

- 13.4 Allowing top quality people who are currently below board level in (say) the FTSE 350 companies to obtain their first post as a non-executive director in another company could be useful for both parties. As well as operations/line managers consideration might be given to such specialist functions as HR, risk management, company secretarial, internal audit as well as financial controllers. Such individuals could make a significant contribution to the depth of understanding of the company's business in key areas. To widen the mix, additional crossing of the industry barriers by recruiting (say) retailers or e-commerce people onto the boards of production companies and visa versa could help.

International considerations

- 13.5 Whilst some international companies have already achieved the following, we suggest that for companies operating internationally and based in the UK there may be scope for some more international representation on UK boards. Greater international representation could improve the variety of approach and global awareness. Non-executive directors from the USA, the Far East as well as from Europe could bring a different type of experience to a board. This may become more relevant as rules and practice within the EU become harmonised. International representation also provides a larger pool of potential non-executive directors.

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?

- 14.1 We reiterate the issue raised in Question 12 about director liability. There must be a sensible link between risk and reward. Consideration needs to be given to both sides of the equation. Proportional liability, or perhaps capped liability by way of contract, are important issues to be considered. Without a reasonable solution, there will be problems in retaining, let alone recruiting, the best and experienced individuals that are needed by UK plcs.
- 14.2 On the reward side of the equation, with the increasing demands and time commitments being placed on the non-executives (as well as their potential liabilities), the rewards need to recognise the personal risks involved. They may currently be too low to justify the risks. To recruit the best and the most experienced means that remuneration will need to be based on a commercial rate. Committee chairman carry additional responsibilities and the level of their remuneration should be calculated accordingly.
- 14.3 The fee package for non-executive directors will vary. Payment in shares is acceptable, but the majority of the fee package should be remunerated by way of salary or the payment of a fee. The chairman should be aware of the risk that a non-executive director could become financially dependent on a company and thus

potentially loose independence and objectivity.

- 14.4 There is some debate about whether non-executive directors should receive share options. We suggest that share options are now not appropriate in publicly listed companies. The potential gearing in the value of such instruments might tend to detract from independence.
- 15. Do you have comments on the issue of risks or insurance provision for non-executive directors?**
- 15.1 Recent events and, in particular, the writs against the former board of Equitable Life have highlighted the potential liabilities of non-executive directors.
- 15.2 Insurance is essential. All companies must provide adequate insurance for all members of the unitary board. Traditionally this has been via ‘Directors and Officers’ insurance. In the current market, it is likely that D&O insurance will be more expensive and less comprehensive and this will cause problems in recruiting or retaining non-executive directors.
- 15.3 In a worst case scenario, D&O insurance may be unavailable; there is no obligation for insurers to provide it. If this were to be the case, consideration may have to be given to a process of self-insurance by which a company itself sets aside funds to protect directors and would require changes to company and tax law to make it permissible and effective.
- 15.4 For non-executive directors, insurance from whatever sources could be linked to any liability caps that may be available in their contracts.

Section 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?**

Combined Code

- 16.1 The UK has been, and continues to be, at the forefront of corporate governance. We are acknowledged to be of a world class standard and this is primarily due to the Cadbury Committee’s Code of Best Practice and its successor, the Combined Code. Overall, we believe that the Combined Code is working well, but it should be kept under review. The approach of comply or explain appears satisfactory.
- 16.2 Codes are more adaptable than legislation. Keeping the Combined Code under review will help to ensure that it takes account of changing circumstances. Additional

material in the area of audit committees has been suggested by recent review groups in the UK and elsewhere (see Question 18). This may also be an opportunity to consider whether there is a need for some more transparency about the operation of a board's committees and also a review of the quality of corporate governance / Combined Code disclosures in annual reports.

- 16.3 Any updating of the Code should, however, be undertaken in such a way that it does not undermine the concept or the functioning of the unitary board. We strongly recommend that any proposed areas of change or new material is exposed for consultation before being finalised.

Code provisions on board balance

- 16.4 The balance between executive and non-executive directors has to be flexible, allowing for the needs of different companies at various stages in their development. In the longer term, larger listed companies could have a simple majority of non-executive directors on its board, moving it up from the 'not less than one third' (Code provision A.3.1).
- 16.5 The disclosure requirements are working well in the area of board balance. Based on the brief CV of each director that should appear in an annual report, shareholders will be able to form their own judgement on the suitability of the individuals and, if appropriate, take up any concerns with the company.

Definition of independence

- 16.6 There are a number of representatives of institutional shareholders each of who have developed guidance on the meaning of 'independence'. Criteria from these documents include:
- making the length of tenure as a non-executive director as an element of any independence definition;
 - previous service with the company in an executive capacity;
 - significant personal shareholding or as nominee of a related party; and
 - dependence on the company for financial reward.
- 16.7 Whilst all the above have varying degrees of merit, we would be concerned if legislation or regulation imposed 'independence criteria'. It would then be all too easy for the selection of independent non-executive directors to be made using a box-ticking approach. In such a situation, the best people may not be chosen and those who have 'a tick in all the independence boxes' may prevail even if they may not be able to achieve the required standards in other areas.

Duties and responsibilities of the non-executive and executive directors

- 16.8 Whilst not necessarily part of the development of the Combined Code, guidance should be considered to clarify the duties and responsibilities of the non-executive director and distinguished from those of the executive directors and vice versa. Whilst in the UK we may not have two tier boards, in practice the non-executive directors are monitoring the executive directors.

- 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?**
- 17.1 The Combined Code should continue to set the parameters but there should be in future a majority of non-executive directors on the boards of larger companies. After that it should be up the companies to define their own board structures.
- 17.2 Structures help, but for board meetings to work effectively the role of the Chairman is crucial. In practice, meetings will be effective or not depending on the Chairman's ability and experience, the quality of the individuals on the board, and the commitment of the board as a whole.
- 17.3 Board size is dependent on type of company although they should not be too large so as to become difficult to manage. The executive committee is the place for many of the functional directors who do not sit on the main board.
- 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?**
- 18.1 Provision D.3.1 of the Combined Code states there should be at least three non-executive directors on the audit committee, a majority of whom should be independent non-executive directors. We believe that all members of the audit committee should be independent non-executive directors.
- 18.2 Provision D.3.2 refers to the audit committee's duties in relation to auditors including the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors (we believe that this applies to both external audit and internal audit). The provision also refers to the provision of non-audit services by the external auditor. Currently the audit committee is most likely to make recommendations to the board on matters to do with the auditors.
- 18.3 Recent reviews undertaken in the UK and elsewhere have suggested that the audit committee should make recommendations directly to shareholders on the hiring, re-appointment and removal of the external auditors, and on their remuneration. These reviews go on to suggest that the committee should approve non-audit work that is to be undertaken by the external auditors to ensure that such work will not compromise their independence or objectivity. In practice, the approval for such work could create some practical difficulties. For example, between meetings, should this be delegated to the Chairman of the audit committee, and then the Chairman's decisions should then be discussed and approved at the next available meeting of the committee? Alternatively, should the audit committee agree in advance the policy for allowing the external auditors to undertake work (such as due diligence on acquisitions), and then (a) monitor the outcome and (b) pre approve any variations on an individual basis?
- 18.4 Whilst all members of an audit committee should have basic financial literacy and an

enquiring mind, at least one member of the committee (preferably the chairman) should have an accounting financial/background. Consideration should be given to whether this number should be increased for large and complex companies/groups. It is also important that the members of the audit committee have an understanding of corporate governance (especially the role of the audit committee therein) and the principles of risk management (including risk mapping).

- 18.5 Audit committees are increasingly at risk of overload because of tasks additional, but linked to financial reporting and auditing such as internal control and matters associated with the review of the management of risks. There are also suggestions that they should look more into Codes of Conduct and internal whistle-blowing procedures. In order to meet their remit it is most likely that the length, if not the frequency, of audit committee meetings will need to be examined and possibly increased. Boards will need to ensure that there are sufficient resources and support available to the audit committee.
- 18.6 There are areas where the existing provisions on audit committees could be strengthened. These include D.3.1 and D.3.2 as noted above. D.3.1 refers to the audit committee's terms of reference (often called an audit committee charter). Consideration could be given to the public disclosure of the charter on the company's website with notification of its existence in the company's annual report. Good practice is best developed via the disclosure and transparency route, and we are giving consideration to the developments of some model disclosure statements on audit committee for inclusion in annual reports.
- 19. Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?**
- 19.1 The duties of the nomination or the remuneration committees are not a problem. We suggest that the remuneration committee should be composed solely of non-executive directors and chaired by an independent non-executive director. There are arguments that the same should apply to the nomination committee, but on balance the nomination committee should also include some executive directors but be chaired by a non-executive.
- 19.2 The operation the remuneration committee has clearly come under scrutiny recently. With the issue of the Directors' Remuneration Regulations 2002, rewards are much more likely to be linked to performance and the work of the committee is likely to remain under close scrutiny by shareholders and the media.
- 19.3 The importance of the nomination committee should not be understated as it is via this committee that the appointment of the future leaders of the company is made. We suggested in 12.2 that consideration might be given greater transparency and disclosure about the selection process and criteria used for the selection of directors.
- 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?**
- 20.1 We believe that almost all boards have processes for setting objectives, through

strategic and business planning and budgeting. The processes for board review are likely to be variable, and it is possible that fewer boards may subsequently review these objectives with sufficient rigour. Individual directors' performances may suffer from the same lack of attention.

- 20.2 All directors, including non-executive directors, should be subject to an annual review and the nominations committee could be a sensible guardian of the assessment process. It allows directors themselves to comment on the dynamics of the board, the effectiveness of individuals and is likely to deal much more effectively with non-attendees and under-performers. In answer to some other questions, Appendix C includes some attributes that could be used as part of the assessment process. In addition, the use of external facilitators should be encouraged.
- 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?**
- 21.1 Internally: within many companies, it is likely that more could certainly be done to review performance. It is important that a non-executive director contributes directly to the productivity and competitiveness of the board and not develops merely as a control or regulator.
- 21.2 Annual assessments of the effectiveness of the board and its various committees should be carried out and this could most usefully be achieved as a self-assessment exercise, perhaps facilitated by an external third party.
- 21.3 Externally: transparency is important but should be limited to the process of review and an acknowledgement that they the annual reviews have taken place. It is difficult to imagine how the results of the review could be fairly and objectively conveyed to shareholders as performance measurements are necessarily individual as well as collegiate.
- 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?**
- 22.1 Non-executive directors can achieve much in terms of influencing decisions behind the scenes, but this largely depends on their independence, their character and teamwork with the other non-executive directors. It also requires transparency at board level so that all board members understand the issues. In a well-run board contentious issues should be subject to debate before decisions are taken.
- 22.2 Exposing serious problems can be harder although improved information and better discussion on risk management issues have helped to ease the problem. Non-executive directors need to ask challenging questions all the time, being prepared to acknowledge a lack of detailed knowledge or a need for explanations, and to probe until satisfied with the answers and information provided. This particularly applies to new issues as they arise. If there are contentious issues then, where possible, the board should deal with them twice. Once for debate and then again (possibly at a later

date) for decision.

- 22.3 To make matters easier for the non-executive director, it should be emphasised by a board to all employees that the non-executive directors have the right of access to, and information from, any relevant employee (especially such functions as compliance and internal audit).
- 22.4 Any director's ultimate sanction is to resign before the expiry of his or her period in office. To help a resigning director expose problems, consideration could be given by the Review Team, either via legislation or regulation, to a requirement that a resigning director provide information that would be publicly available as the reasons for his/her resignation. Such a move should concentrate the minds of the executive management and raise issues with the shareholders. In these circumstances, the director may need to be given better protection/effective privilege as there will no doubt be many legal issues, including those related to employment contracts. Resigning directors will also have to take into account many other considerations including (a) other avenues for the expression of their concerns and (b) the potential damage to confidence in the company that such a resignation statement might bring.

Section 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?**
- 23.1 We support the unitary board and would not want to see a process that creates problems between the executive and non-executive directors. The main relationship between non-executives and shareholders should be on an equal basis with, and led by, the executive directors. This process will directly expose the non-executive directors to the views of the shareholders.
- 23.2 There may be times when direct contact between the non-executive directors and institutional shareholders is essential when, for example, the shareholders have concerns on matters such as executive remuneration, corporate governance, or matters related to the work of the audit committee. Contact with the non-executive directors as a group and usually via the Chairman or the senior independent non-executive director should allow shareholders' concerns to be raised and fully debated at board level.
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?**

- 24.1 The Chairman, not the Chief Executive, should set the tone for a fully effective board, and the success of this depends entirely on the individual Chairman and his or her style and experience.
- 24.2 Although there should be a sufficient number of board meetings during the year, a key limitation on the effectiveness of non-executive directors (although it can equally apply to all directors) is an inadequate flow of relevant information on a timely basis. See our comments on information in Question 27.
- 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?**
- 25.1 Above all, relationships should be open and honest. The non-executives should have access to both the Chairman and the Chief Executive at all times and be free to talk to any other member of the board. It is also essential that the board and especially non-executive directors be given opportunities to meet senior management. This is beneficial for governance, succession planning, knowledge and motivation. It can also be useful for certain non-executives to mentor executive colleagues.
- 25.2 Whilst non-executives should have access to advisers, in general terms, it may not be really practical for them to be the main point of contact. Advice could be channelled through one or two key people on the board, such as the Chairman, or via the Company Secretary. In the case of the audit committee requesting such advice, the information should be sent directly to the committee.
- 26. How can Company Secretaries support effective performance by non-executive directors?**
- 26.1 Company Secretaries have an important role to play and the efficiency of the administration of his/her department is an important factor. Non-executive directors can be heavily dependent on the Company Secretary as, being aware of the key issues, he/she can be a source of a considerable amount of information to the board and its committees. In particular, the Company Secretary should regard himself/herself as a key support to the Chairman. The Company Secretary could also hold a budget for director training.
- 26.2 As noted in Question 27, information is key to the well-briefed board and non-executive director. The appropriate papers must be presented to the non-executives and the Company Secretary is usually the conduit for the provision of information on a timely basis, including minutes, regulatory and legal documents. They can be assisted in this task, as well as in the provision of proper operational information on the business, by other functions within the company such as the finance and compliance departments, internal audit and risk management.

Section 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?**
- 27.1 Information is key to the effectiveness of the non-executive director. It helps them ask tough questions and assists them to understand the answers. They must receive, in a timely manner, all the information that they consider necessary for them meet their obligations and to be able to understand and monitor the performance of the business.
- 27.2 The non-executives should have the right, but not the obligation, to receive all the information available to the executive directors and be given whatever information they ask for without question. External information (e.g. press and analysts reports) and competitor information is just as important as internally generated information.
- 27.3 There is a debate as to the quantity of information that the non-executive directors should receive so that they are not overloaded. Too much information is probably better than too little, but the key is the time spent on deciding what is important.
- 28. What training and development opportunities are available? Could they be improved and, if so, how?**
- 28.1 There are a number of organisations that run general courses for non-executives. Although the time of busy people is necessary for training and updating, companies should ensure that all their non-executives attend general induction and update courses (internally or externally provided) on the role and duties of non-executive directors. This applies particularly those who are newly appointed non-executive directors and to those whose roles become more technical such as a member of the audit committee.

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

- 29.1 In many companies, employee induction courses are available. It is both useful for the non-executives and encouraging for the employees for the non-executive directors to participate.
- 29.2 At the commencement of his/her appointment, the new non-executive director must undertake a comprehensive and carefully structured (in-house) introduction to the major operating units of the business. This should enable him/her to better understand the complexities of the business, data he/she reviews as well as the initiatives being proposed. This is particularly relevant if there is a dominant CEO. Non-executive directors must also fully understand their legal and fiduciary responsibilities.

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?

- 30.1 External guidance: institutional shareholders have some role to play in stating what the shareholders expect of the non-executive directors. It helps if the individuals from the institutions have practical experience of working in businesses and may thus be better able to understand the practicalities of business.
- 30.2 Internal guidance: some issues may be covered in annual review of the work of the board etc. The Chairman may give feedback.
- 30.3 Small company sector: here the non-executive directors are chosen specifically because they have the experience that will enable them to know what is expected of them. We suspect that there is little or no evidence of such guidance and feedback in this sector and that this is one area that could be improved.

Section 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?**

- 31.1 Whatever the size of the company, the role of the non-executive director involves (a) contributing to the development of the company's strategy; (b) the provision of valuable expertise and support may not otherwise be available; as well as (c) a monitoring role. The balance between the three components may vary from company to company and from large to small, but all remain equally relevant.
- 31.2 There are, however, significant differences between a FTSE 350 (or large listed company) and a small listed company. Whilst boards may be able to attract the required number of good non-executive directors to smaller listed companies, their resources and support processes will not be the same as in the larger companies. This has implications for compliance with Code provisions.

- 31.3 To be able to accept funds from investors, there have to be obligations on all boards to adhere to the principles of corporate governance. There should therefore be no latitude on the application of Code principles and we would discourage any differentiation on principles for different sizes of company.
- 31.4 However, investors in smaller companies should not necessarily expect the same high standards of full compliance with Code provisions as they should expect from larger (say the top 350 or 500) companies. With fewer resources and problems of cost constraints, Code provisions may be proportionately more onerous for small listed companies and this could lead to a "box ticking" approach to compliance. It will be necessary for the non-executives to judge the extent of non-compliance and be satisfied that it is not merely an excuse not bothering to comply with Code provisions.
- 31.5 We suggest that the answer, as identified rightly by the Cadbury and Hampel Committees, is more transparency and disclosure. Smaller listed companies must make full disclosure of all non-compliance with Code provisions backed up by good reasons. This, combined with an understanding by the market that all efforts have been made by the board of a smaller listed company to comply with the Code provisions, should go some way to assist smaller companies.

Section 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?**
- 32.1 Whilst the UK has been a leader in the corporate governance arena since the publication of the Cadbury report 1992, there are no doubt lessons that we can learn and ways that we can improve. Much of this may surround the strengthening of the audit committee but within the unitary board system.
- 32.2 We believe that the unitary board has served the UK well. As the single governing body, the members of the board of directors, all of who are appointed by shareholders, should receive the same board papers allowing them to participate (on the basis of the same information) in the decision-making process. This process gives the non-executive directors a better chance of getting to the core of the company than might be the case in a two-tier system.
- 32.3 The unitary board is particularly appropriate in a system, such as that in the UK, that is shareholder orientated and where there is a strong and diverse group of shareholders with highly liquid capital markets. The rights of other shareholders with legitimate interests in the company such as employees, customers and creditors are protected by their contract and by other law. Boards will recognise their responsibilities to such stakeholders for the good of the company and its reputation in the marketplace, but their accountability is solely to shareholders.
- 32.4 In countries that are more societal-orientated and where recognition is given to the interests of other constituencies affected by the activities of the company, the two-tier

board has a major influence. A particular example is Germany, where the capital markets are less liquid and there tend to be connected owners and cross-holdings. The members of the supervisory board are all non-executive directors and often comprise employees of the company appointed through their trade unions. The law forbids any common membership between the supervisory board and the management board. Independence is more overt with this structure but do supervisory board members have a chance of to fully participate and get to the core of the business as identified in 32.2 above?

32.5 The US has an alternative unitary board model. Their boards have considerably more non-executives than executives. Probably the real problem with the US model is the combination of the Chairman and CEO with the concentration of power that this brings to one individual.

32.6 Whilst not completely ruling out the two-tier board, and we do need to define the duties and responsibilities of non-executive directors in the unitary board (see 16.8), we suggest that a main lesson from abroad is that two-tier structures are less likely to be the answer in the UK context. The US model has been shown to have significant problems in a number of situations. What is needed are boards that have a good mixture on executive and non-executive directors who meet regularly and all receive the same information.

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

33.1 No. We do not see any other model which offer significant advantages. The comments to question 32 also apply here.

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

34.1 No. The way forward needs to be evolution driven by transparency rather than radical changes or a plethora of rules which could well have unintended consequences. International practice may be moving towards the UK model, and we should lobby hard for other countries to adopt UK style solutions, not the other way around.