

Review of the role and effectiveness of non-executive directors

Consultation Paper

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A: Role

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

Possible issues for comment:

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

The role of the Board is to ensure that the affairs of the company are being managed in the best interests of all of the Stakeholders. The role differs from that of the executive management team in that whilst the latter is primarily concerned with operational matters, the Board is primarily concerned with strategic matters. From time to time conflicts will arise between the interests of different groups of Stakeholders, in which case the Board must strive to ensure that there is a reasonable balance maintained between the different interest groups having regard to compliance with company law and other corporate governance guidelines. Key areas of focus include:

- ensuring that a proper planning process is in place
- ensuring that adequate resources are allocated in line with the plan
- reviewing progress against the plan
- taking whatever corrective action is necessary with regard to the management of the company

The role of the Chairman is to lead the Board in executing its responsibilities. Whilst in theory at least all members of the Board have a shared interest in acting in the interests of all of the Stakeholders, it must be recognized that executive directors, as employees of the company, may have a conflict of interest from time to time, when acting in their capacity as directors. Consequently, the Chairman needs to be alert to such a possibility, and be prepared to guide the non-executive directors in this regard.

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 role of non-executive directors should be to play a full part in the 4 areas of focus outlined in our answer to question 1. We do not see the issue of “balance between the different components” arising: the non-executive directors must play a full role in all matters relating to the strategic development of the company, and its compliance with legal and corporate governance issues.

Whilst the Board may choose to delegate some functions to Sub Committees e.g. Audit, Nomination or Remuneration, we do not believe that this lessens in any way the responsibilities of the non-executive directors in respect of those or any other matters. Indeed, company law in the UK refers to what directors know or ought to have known, ignorance is not an excuse nor a defence to malpractice.

3. How does this compare to the present position?

The present perception in the market is that non-executive directors have a less influential role than executive directors within the structure of a board and thus have lesser duties in this respect. Our view is that this does not change the present situation in any way. However there is probably scope to underscore this point. One way in which this could be dealt with would be a new provision which would make it mandatory for the non-executive directors to sign a “Statement by the Non-Executive Directors” in the Annual Report to the effect that they had made

what they considered all relevant enquiries from the executive team as to the “true and fair view” of the company as contained in the Annual Report and Accounts and that they believe that they fairly present in all material respects the financial condition and results of the company. By ensuring that the non-executive directors, publicly stand by the annual reports will ensure that more attention is paid to these reports and that non-executive directors will understand and accept the role that is expected of them. Although this may deter individuals becoming non-executive directors, it is important that non-executive directors understand their responsibilities. Steps need to be taken to ensure that this is managed carefully and that the non-executive director pool is continually growing in size and quality, especially for SMEs and start-ups who badly need non-executives on their boards.

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

We don't see that there is a difference in their responsibilities as directors to the company's Stakeholders. However, as we pointed out in our response to question 1, executive directors can encounter a conflict of interest in respect of their role as director and executive. As a consequence the non-executive directors must be conscious of this possibility, and factor it into their own actions when making decisions.

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 principal areas of conflict of interest arise around the remuneration and employment contracts of the executive directors. These include salary, bonus, share options, pensions and severance payments, and any event act or deed by the company that can impact on these. Generally speaking non-executive directors do not participate in such benefits, and therefore are ideally placed to oversee that “reasonable” remuneration prevails, and that best practice is observed.

This will particularly be an issue in respect of early stage/start-up proposals. The experiences, contacts and skills of a Ned maybe the catalyst to accelerate the growth and development of a business an indeed attract third party investment. The only way to remunerate such individuals may be through deferred salaries/capital appreciation through share options.

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?

We do not believe that this question can be answered objectively, as it ignores the very real fact that the time commitment (and hence the “number of non-executive posts”) should be determined by the complexity, diversity, and level of change being undergone by a company. Furthermore, one must factor in the other commitments the individual in question already has.

For example, we would argue that a senior executive of a FTSE 100 company should not perhaps take on more than one other directorship of another FTSE 100 company. However if the directorship(s) in question were say a number of inter-related small family businesses or local charities, five or six of such non-executive directorships would be unlikely to prove over-demanding.

Again we would argue that for someone who had taken early retirement, it would not be unreasonable that they should consider holding say five directorships of relatively large companies. On the other hand, if the companies concerned were essentially investment funds where all services were subcontracted to third party professional service providers (fund managers, administrators, custodians etc.) we do not believe that the number should not be

twenty or more. Individuals that hold full-time employment roles as well as being non-executive directors need to ensure that they do not take on more than they can manage.

Regarding time commitment, the answer lies in whatever is needed to discharge their responsibility. Whilst this answer may appear at first sight to be unsatisfactory, we believe that our recommendation regarding the Statement by the Non-executive-Directors to question 3 above would heighten the awareness of the non-executive directors and act as a strong discipline to individuals from taking on responsibilities in excess of their capability to discharge them.

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

Yes, but only in cases where the Chairman is not clearly independent of the executive team. However we would prefer to see a situation where the Chairman was the “senior independent” non-executive director.

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

The proposed statement is a move in the right direction to increase the awareness of the role of non-executive directors and the duties and responsibilities that come with the position.

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?

Possible issues for comment:

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?

The key skills, knowledge and experience required are simply those that are likely to add value to the sustainability and growth of the company. They can come in many disciplines e.g. finance, production or marketing. We do not see major change, other than one must recognize that business life tends to increase in its complexity, and consequently the demand for high quality non-executive directors is likely to increase over the next 10 years.

The key essential skills revolve around the ability to analyse situations so as to provide a balanced and informed decision which the non-executive director believes to be in the best interest of all of the Stakeholders.

10. What personal qualities and attributes are needed?

Business and board experience, network of contacts, independence of thought, ability to express and communicate, and tact.

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.

This will vary from company to company. Companies should seek to balance their board in a way that eliminates any perceived weakness, and enhance opportunities for them to optimize their

growth prospects. Accordingly the reason for appointing specific individuals to non-executive posts can vary from strengthening the finance function to ability to enter new markets, to working with new or potentially new trade partners.

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

We believe that the real issue may center on the size of the available pool, and believe that perhaps greater efforts should be made to promote the development of that pool e.g. through greater public awareness of the role etc. or non-executives and preparing/educating them for the task.

We are not inclined to the view that a Nominations Committee per se is the answer – rather we prefer stressing the “independence” role (combined with the Statement by the Non-Executive 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?

The core issue at present, as EquityNetwork is finding out, is that there is no shortage in suitable candidates for non-executive director positions but rather a lack in demand for such candidates. To ensure that the demand increases, government needs to be such so as to attract the interest in the small-medium enterprises across the country in utilizing such candidates and increasing the awareness of the benefits NEDs can bring to a company.

The issue implied by the question is that companies don't always act in the best interest of all their Stakeholders in appointing non-executive directors. Of course the shareholders have the power to alter this, but are usually apathetic in this regard.

We do not support a move however that would introduce a mechanistic guideline as to the appointment of more diverse board or international “quota”. However it may be worth considering obliging companies to provide their shareholders with more details of non-executive directors “qualifications” and by implication, what they are contributing to the development of the company.

One solution may be for shareholders to have to agree to the appointment or approval of both non-executive directors as well the executive members to the company Board at the Annual General Meeting, rather than a single approval for electing the entire Board. This will raise the awareness of the existence of non-executives on the Board among shareholders and highlight the importance and responsibility that comes with this role.

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?

We believe that this is an issue that the market decides. We recommend a twin pronged approach to the issue by (a) making non-executive responsibilities more visible e.g. via the Statement by Non-Executive Directors and (b) increasing the supply side through greater awareness and education e.g. support for the IoD education programme.

The use of share options as an incentive to non-executive directors to help guide the business to success needs to be carefully monitored to ensure that it does not skew the objectivity and independence that a non-executive is to bring to a board.

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

If quality non-executive directors are to be encouraged to join Boards, it is essential that they are provided with directors liability insurance – which should be an expense of the company.

Standardised templates and contracts should be developed by appropriate associations/government departments to make clear, publicly, what shape a non-executive director contract should take and outline the liabilities involved. It is important that such a contract process does not become onerous and thus deterring capable individuals from becoming non-executive directors.

C: Structures and accountability

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

Possible issues for comment:

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

We believe that the Combined Code has been a significant step forward. However we believe that it could be strengthened by suitable wording being included in our proposal for a Statement by the Non-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?

We favour the use of board committees to assist in some of the more detailed work of the board. However the existence of committees should not in any way diminish the responsibilities of all directors, whether they sit on a committee or not.

Generally speaking we believe that board meeting procedures are well understood, with particular responsibility resting with the company secretary to ensure that this occurs.

We have no particular comment on board size – whilst smaller companies can adequately transact their business with 6 or 7 directors, larger companies benefit from a higher number. However a question arises in our mind that if the number rises above say 15, does this not make it somewhat easier for a non-executive director to opt out from discussions and decision, thus raising the potential for the executive directors to force their (possibly conflicted) interests through?

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 no direct experience of Audit Committees, but they appear to us to be working effectively. The critical elements appear to us to be that they should be composed entirely of non-executive directors, and that they should be free to access whatever information or company officer chooses and without the presence of any other executive (also if it so chooses).

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

Again we have no direct experience. We have no comment to make on the Nomination Committee. With regard to the Remuneration Committee, we have noticed in some cases a tendency for the composition of these committees to be made up of some of the wealthier/higher paid members of the board.

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 there are a number of well documented processes in place, our view is that they are not applied by the majority of companies.

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?

Yes.

Yes, e.g. attendance and voting record. (This in itself may produce relatively meaningless information, but it will assist in keeping the pressure on non-executive directors to take their responsibilities seriously.

Yes, where appropriate. Attendance records and voting records if available.

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?

They can, but often it requires sustained pressure – with the consequence that the challenge is not mounted. We believe that it is important to recognize that within the heading of non-executive directors, there are two types of individual: those who are genuinely independent of the company; and those who are not so (due for instance to the fact that they are former executives, are closely related to the Managing Director, Chairman or other senior executive, or a supplier of key services e.g. insurance broker.) As a consequence we believe that for companies of a certain size e.g. listed on a Stock Exchange, there should be a minimum of approximately 30% of the Board made up of “independent” non-executive directors. We believe that this would make it “easier” for them to challenge and expose issues.

D: Relationships with shareholders and others

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

Possible issues for comment:

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

We would not be inclined to develop a direct relationship between shareholders and non-executive directors. (Should this suggestion be developed, we dislike the concept of a

shareholder who happens to be classified as “institutional”, having rights superior to one who is not). We see a number of problems arising in that (a) we believe that it is the responsibility of the executive team to brief shareholders as they deem appropriate (b) introducing non-executives into this arena could send out mixed messages and (c) that our recommended “sign off” via the Statement by the Non-executive Directors should adequately allay concerns of the (institutional) shareholders. As mentioned previously, the possibility of having shareholders having to separately approve the executive directors on the Board and the non-executive directors rather than the Board as whole will raise the profile of the non-executive directors.

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?

At present this varies from Chairman to Chairman. We believe that more can be done (via a Code of Practice) to highlight this critical role.

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?

Our response to this is based on the principal we outlined in our answer to question 1: the executive team are responsible for operational matters and the board for strategic matters. So in dealing with executive directors in relation to strategic matters, the relationship should be one of equals. When dealing with executive directors and senior managers on operational matters, the relationship should be defined as what is reasonable in satisfying themselves that the key areas of focus (which we outline in our answer to question 1) are being dealt with in an effective and efficient way. Their relationship with the Chairman should be open – both ways in that if corrective action needs to be taken, the non-executives should feel comfortable discussing an issue outside the boardroom. With regard to the Chief Executive, see above – depending on whether it is a strategic or operational issue.

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

The Company Secretary is in effect the “conscience” of the company, and should be not only readily accessible by all of the non-executive directors, but equally should be free to discuss any matters that he feels to be relevant with them – somewhat akin to the relationship between the Internal Auditor and the Audit Committee.

E: Support

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

Possible issues for comment:

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?

To a large extent the answer to this question depends on the skills and experience of the non-executive director and agreement and structure of the Board. A “good” non-executive director will know when to seek out further information, and so will by definition be effective. An inexperienced non-executive director may however not be aware that the communication channels are somewhat restricted. In short we believe that this is an issue around training and experience, rather than communication channels.

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

Develop appropriate courses – in conjunction with service providers such as the IoD. Provide in the Code that all directors – including non-executive directors - being encouraged to attend such a course on appointment, and a “top up” refresher course at regular intervals e.g. most directors are appointed for a 3 year term, and the refresher course could co-incide with their re-appointment.

These training courses and the structure of such should be aligned with recommendations from the Code and the Government rather than decided upon by private providers.

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

Standards can always be improved!

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?

In most cases, probably not. As we mentioned in our answer to question 20, there is scope for strengthening performance review – both for the board as a unit, and individual performance.

F: Smaller listed companies

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

Possible issues for comment:

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

We believe that the same principals should apply. However smaller companies are quite often – but not necessarily – less complex, and accordingly their overall performance may be more optimal with a smaller board, fewer Board Committees, and less emphasis on formal processes.

G: International context

What can we learn from international experience?

Possible issues for comment:

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

In general we believe that the UK system is basically sound as evidenced that the UK system of accountability stands up well in comparison to a number of well publicized scares and scandals in some of our major competing markets. However we believe that some version of the recent US Sarbanes-Oxley Act but targeted at non-executive directors (from which we derived our Statement by the Non-executive Directors) is worth serious consideration.

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

We believe that the basic UK model is sound. However there is potential weakness in that if the non-executive directors – and in particular the “independent” directors are less than vigilant, effective control can become over-centralised: hence the need to place the role and accountability of these directors more “center stage”

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

We see no compelling case for this.