

REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS

Submission by the Investment Management Association

1. The Investment Management Association (IMA) is the trade body representing the UK asset management industry, representing some £2 trillion funds under management and over 99% of the UK investment funds industry (unit trusts and oeics). In managing assets for both retail and institutional investors, IMA members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in the Review from the standpoint of institutional shareholders. The key issue from IMA's point of view is the contribution that non-executive directors can and should make to an effective and constructive dialogue between companies and their shareholders.

The roles of Boards and Shareholders

2. All stakeholders in a company share a common interest in good governance and effective performance. Ultimately, it is the duty of the board to secure that, and to account for its stewardship to shareholders and to the market. The last 10 years have seen a series of reviews and initiatives intended to improve governance. The IMA believes that, taken overall, the result has been a significant increase in standards of corporate governance in the UK, and that fundamental change to the structures put in place by common law, statute, the Listing Rules and the Combined Code is not required. Where issues arise, they are in general more about how effectively the arrangements work in practice than about whether the structures are correct.
3. In particular, the IMA believes that the UK structure of a unitary board is an effective form of governance, which does not need to be changed. We do not consider that alternatives such as the dual supervisory/executive board structure seen in certain other countries are as effective in that they tend to add extra layers to the decision process and no one body is responsible for the company overall.
4. Within that unitary structure, different individuals have different roles. The IMA believes that there is a clear, distinct and important role for directors who do not form part of the executive management team running the company day-to-day. By bringing a fresh mind to a problem, unhindered by the detailed debate that will have gone on in the run-up to a proposal, they can provide an important leavening of the decision process. With an independent but informed perspective on key decisions, non-executives can bring fresh ideas and thinking to bear. They can also ensure that proposals from executive management are thoroughly and rigorously tested before being finalised and acted upon.
5. Independence from management is thus a key qualification for the role. The IMA broadly supports the definitions of independence used by the Association of British Insurers and National Association of Pension Funds and considers that all companies should adopt these principles.

6. There are other aspects to the role of non-executive directors: -
- counselling and supporting executive management;
 - bringing wider skills and experience to bear than maybe available within the executive management team;
 - potential new business opportunities through their own contacts and networks;
 - ensuring the independence of the audit, nomination and remuneration processes;
 - looking out for the interests of shareholders.
7. These functions are all connected and inter-related. Thus we do not believe there would be merit in designating particular non-executive directors as, in some sense, "representing" particular interests (except naturally in the case of audit, remuneration and nominations where board sub-committees are established and a non-executive director needs to be appointed as Chairman). To give particular non-executive directors specific responsibilities would serve only to undermine the board's responsibility to manage the company in the collective interest of all its stakeholders. It follows that IMA would not favour designating a particular non-executive director to represent the interests specifically of shareholders.
8. The one possible exception to this principle is the appointment of a representative of a particular large shareholder, something that would normally be considered only if the shareholder had a very significant interest in the company, which creates special circumstances and is the ultimate expression of shareholder activism.

What changes are needed?

9. The IMA believes that the existing framework for corporate governance is satisfactory. How that framework works in practice will depend on how the individuals concerned act. Ultimately that is not susceptible to prescription by codes and by structures. It is about getting the right people into the right jobs.
10. Nevertheless, we think there are reforms which could be considered which would help this process.
11. A particular concern for institutional investors is how to communicate concerns they may have to a board. While regular meetings will normally be held with the executive management team, these are not necessarily the best forum for communicating broad views or concerns about the company's governance or about its strategic direction. Although shareholders hold the ultimate sanction of being able to vote a board out of office or to vote against its strategic direction, resort to such measures is neither an effective nor a desirable way of exercising control. Shareholders have to look to the board, and in particular to non-executive directors, to manage their interests in the company in such a way as to anticipate and avoid problems. Non-executive directors have access to all confidential information in the possession of the board, and are therefore in a much better position than shareholders – who

have only the information available to the market as a whole – to exercise control.

12. There needs however to be a proper conduit of communication which is open to shareholders, other than direct to executive management. There may be cases where shareholders believe management should be challenged, and it is for non-executive directors to do this. They need to be in a position to communicate their concerns to those non-executive directors. The IMA therefore supports the concept of the "senior non-executive director", and would welcome its extension much more widely. The senior non-executive director might or might not hold a position such as chairman of the board or chairman of the remuneration committee. The key considerations would be that the individual was fully independent of the company and the management, and was somebody of weight and standing with significant influence within the board. Part of the role would be to maintain informal contact with leading shareholders, so that the person concerned could be used as a channel of communication for shareholder concerns.
13. Not all non-executive directors today fulfil their function as effectively as they should, although there are many who do. The reasons for this vary, but can include: recruitment of non-executives without the required skills and experience; non-executives who are not fully independent; or a failure on the part of non-executives to assert fully their rights and responsibilities. While ultimately no code of practice can prevent this happening, we think it would help if the responsibilities of non-executive directors, including those they might have to fulfil on board committees or as senior non-executive director, were codified more fully than they are now. This would help those taking on the role of non-executive director to understand better what was required and expected of them.
14. The IMA therefore considers that companies should develop statements of the role of their non-executive directors, which would form part of their contracts as members of the board. These statements should be publicly available, perhaps in the Report and Accounts, so that the performance of non-executives against these criteria could be judged.

Summary of recommendations

- I. The existing corporate governance framework is satisfactory and should not be fundamentally changed (para 9). The problems that arise are about how effectively individuals discharge their duties (para 13)
- II. Non-executive directors should be seen to be independent of company management (para 5). This should be better defined, and the existing ABI/NAPF guidance is a good starting point (para 25).
- III. No one director should be designated as the specific representative of shareholder interests (para 7), although a shareholder who has a significant interest in the company could be appointed to represent that interest (para 25).
- IV. A "senior non-executive director" should be designated whose responsibilities would include acting as a communication point for shareholders in certain circumstances. This practice should be extended more broadly (paras 12 and 30-31).

- V. Companies should publish statements about responsibilities of non-executive directors so that these are more fully specified than they are now in the Combined Code (para 14).
- VI. A non-executive director's contract should contain an estimate of the time the individual is expected to devote to the work (para 17).
- VII. Remuneration should be sufficient to attract the right quality candidates but not excessive. IMA considers an appropriate consultancy rate for the agreed time commitment would be right (para 21).
- VIII. Non-executives should be encourage to hold shares in the company but should not have options or be members of the pension scheme (para 22).
- IX. Consideration should be given to the availability of liability insurance as it is likely to become an increasingly important issue (para 23).
- X. Consideration should be given to adopting the terminology "independent director" instead of "non-executive director" (para 27).

A: ROLE

15. We commented in the introduction on the general role of the board, and of non-executives. At present, company law does not distinguish non-executive and executive directors. So long as that remains the case, it is appropriate that any statutory statement of directors' duties, as proposed in the Company Law Review, should not distinguish between the two. The distinction is however clearly drawn in the non-statutory Combined Code, and an expanded definition of the roles of non-executive directors can thus be made in a non-statutory context.
16. The role of the non-executive director is a significant one, and should require a significant input of time by the individual. This is so whether the company is small or large.
17. This inevitably limits the number of non-executive commitments which any individual can take on. We would not propose any limit on the number of non-executive directorships an individual may hold. But we believe all non-executive contracts should contain an indication of the time commitment that will be required. These should be published so that shareholders can assess an individuals' total commitment.
18. As indicated in the introduction, we would support the widespread adoption of the role of "senior non-executive director". This is discussed further in D below.

B: ATTRACTING AND APPOINTING NON-EXECUTIVES

19. The key requirements for a good non-executive director are business experience, and a strong personality. And, as indicated in the introduction, independence from management is critical.
20. Inevitably, there is a limited pool of individuals with the required mix of skills, personality and experience. It would be very desirable to widen the pool of available people, but not by lowering standards. Increasing the numbers of "great and good" available for service as non-executive directors helps nobody. The role of the Nominations Committee is important in this regard.
21. Therefore if more experienced and senior people with the right qualities are to be attracted into this role, they will need to be remunerated properly. As a benchmark, the IMA would suggest that something equivalent to a consultancy rate, reflecting the individual's level of experience and the agreed target time commitment, would be an appropriate level of remuneration.
22. The IMA believes that non-executive directors should be encouraged to purchase modest shareholdings in the company, to indicate their support. But a substantial equity interest – whether in the form of a large personal shareholding or of equity options – would tend to undermine their independence. It could also cut across the agreed remuneration arrangements. Such interests on the part of non-executives should therefore be discouraged.
23. The IMA believes that liability insurance is likely to become an increasingly important issue. A number of recent cases suggest that the vulnerability of directors to litigation is increasing. It would be unfortunate if this became a barrier to suitable candidates agreeing to become non-executive directors. We have no view on whether this has yet become the case, or whether liability insurance is becoming more difficult to obtain, but believe that this is an important matter for the Review to consider.

C: STRUCTURES AND ACCOUNTABILITY

24. As indicated previously, the IMA believes that the broad structures set out in common law, statute, the Listing Rules and the Combined Code are appropriate. In the majority of cases, boards appear to have an appropriate balance of executive and non-executive directors.
25. It is important however that non-executive directors should be seen to be independent. The IMA believes there would be advantage in a more precise definition than is contained in the Combined Code of what constitutes independence. The criteria used by the ABI and the NAPF constitute a good starting point for this, with some modifications.
- Independence should be defined as not previously being an executive working for, or recipient of a payment from, senior management of a company as well as the company itself; a question would exist over the independence of a non-executive director who had received payment from the chief executive in a previous position.
 - There may be exceptional circumstances in which it is appropriate for a director to represent a particular shareholder, for example where that shareholder owns a large proportion of the shares in company. While such an individual may not be fully independent, in that he or she represents a particular interest, they may nevertheless be a valuable conduit for other shareholders. The presumption would be that the interests of the major shareholder represented by that individual would be in line with those of other shareholders. The IMA would therefore regard these as circumstances in which something less than full independence on the part of a non-executive director was acceptable.
26. In terms of the way the various board committees operate, and the capacity of non-executives to challenge the management, the IMA does not believe further prescription is necessary. It is a matter of people doing their jobs effectively. To this end, the IMA thinks there would be advantage in a clearer description of what is expected of non-executive directors, as suggested previously.
27. Indeed, IMA believes that the term "non-executive director" can be open to misunderstanding. While nomenclature can never be argued to be of overwhelming importance, the term "independent director" would, in IMA's view, better describe the role.

D: RELATIONSHIPS WITH SHAREHOLDERS AND OTHERS

28. At present, there is wide variation in the extent to which shareholders are able to communicate with non-executive directors. Inevitably, most communication with companies will be with the chief executive and the executive team, and to a lesser extent with the chairman. In too many cases, however, it stops there. The IMA believes there would be benefit in shareholders' being able to communicate directly with the non-executive directors.
29. This means a channel of communication, rather than a burdensome bureaucratic process. There should be no need for non-executive directors to meet shareholders with anything like the same frequency as executive directors do. Nor does there need to be a formal dialogue separate from that with the chief executive. Boards are and should remain unitary, and shareholders should not seek to drive a wedge between executives and non-executives.
30. However, there is a need for more than is available in many companies now. The IMA believes this gap could be bridged by a more widespread adoption of the practice of appointing a "senior non-executive director", one of whose responsibilities would be to maintain an informal relationship with large shareholders. This might be no more than an annual dinner or series of dinners with the company's main shareholders. This would afford the company the opportunity to sound out shareholders informally about current (non-price sensitive) issues, and shareholders the opportunity to give feedback about any comments and concerns they may have. It would help the non-executives with their duties to review the performance of executive management. Most important, it would open a line of communication that could be used if it ever became necessary.
31. The senior non-executive director might be the Chairman or the chairman of one of the board committees. It would be essential for somebody in that position to be accepted as fully independent from the company and from the management. They would also need to be a person of authority and standing.
32. In some cases, non-executives will naturally have relationships with key advisers. The most obvious is that between those non-executives serving on the audit committee and the auditors. But, beyond those cases where a relationship is necessary for operational reasons, we doubt whether it is necessary for non-executives to cultivate a relationship with advisers.

E: SUPPORT

33. It is clearly important for non-executive directors to have access to sufficient information and support to enable them to do their job effectively. This should include full financial information and access to executive management, including those below board level.

F: SMALLER LISTED COMPANIES

34. The IMA does not believe that separate considerations apply to smaller listed companies. The responsibilities of the non-executive director are the same. The balance of the role may differ. In a very big company, there will be a much greater complexity and multiplicity of financial and strategic choices to be considered. In a smaller company, however there is likely be a greater mentoring role, and the bringing of additional skills and experience to the board may be of higher importance. But that does not mean that the definition of the role should be any different.

G: INTERNATIONAL CONTEXT

35. Various models of corporate governance apply in different parts of the world. In the IMA's view, the UK model stands comparison with the best. Indeed, it is a model to which many other countries aspire. While therefore one should constantly be aware of lessons that might be learnt from international experience, at the present time the IMA believes there are no major changes that need to be imported from other jurisdictions.