

Review of the Role and Effectiveness of Non-Executive Directors: A Consultation Paper

Response by Prudential plc

Key points

- a) We support the role of non-executive director as being a key element of corporate governance in the UK. We believe there is genuine advantage to be obtained by maintaining the unitary board system so that the interplay of executive and non-executive views is brought together in a forum where responsibility is collective.
- b) Non-executive directors bring diversity and breadth of experience to the operation of a company board and so enhance the formulation of strategy and its execution.
- c) Non-executive directors have part time roles and by definition cannot be expected to be as well informed as members of the executive. Directors should not incur personal liability if in good faith they have reasonably relied on information provided to them.
- d) While the non-executive directors are required both to challenge executive proposals and monitor the operation of corporate governance and other controls, it is not realistic to expect that any system of corporate governance will result in a “no failure” environment. The presence of non-executive directors on a board cannot therefore be regarded as giving some form of guarantee of either performance or absence of fraud.
- e) The increasing trend towards individual liability being imposed on executive and non-executive directors can be expected to dissuade able candidates from being prepared to assume the role of non-executive director.
- f) We believe that the exercise of judgement as in the application of the “true and fair” concept is vastly more powerful and effective than a prescriptive regime of box ticking.
- g) Management quality and company organisation are important factors underlying success. An overly prescriptive regime applied on a one size fits all basis will be detrimental rather than incremental to corporate performance and thus to the health of corporate Britain.
- h) Executive management accountability for company performance should not be blurred by mixed messages arising from inappropriate dialogue between shareholders and non-executive directors.
- i) In due course listed companies should identify where they depart from best practice as identified by the outcome of this Review.

Response to questions

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?

Role of the board

1. The role of the Board is to achieve a satisfactory return for shareholders on the resources of the company, and to ensure proper systems of control and risk management are in place.

Role of the Chairman

2. The Chairman is elected by the directors to manage the Board, ensuring it functions properly both in the short and long term, with particular regard to shareholder interests.
3. The Chairman has the ultimate responsibility of reviewing the performance of the Chief Executive and of the non-executive directors and of removing an underperforming Chief Executive or non-executive director.
4. The Chairman liaises closely with the Chief Executive and is responsible for the conduct of Board meetings, for ensuring adequate attention to strategic issues, and for ensuring adequate debate of issues before the Board.
5. The Chairman should ensure the Chief Executive has a clear mandate.
6. The Chairman's role vis-à-vis non-executive directors is to ensure they have necessary information about all matters relevant to the Board and regularly to solicit the views of non-executive directors about the company's strategy and performance.
7. Taking the Chair at the Annual General Meeting, when the Board is publicly accountable to shareholders, does require particular skills and qualities. The Chairman may be regarded as the personification of the organisation when communicating with shareholders.

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?

8. The key roles of non-executive directors should be to:
 - a) Contribute to the development of a company's strategy.
 - b) Monitor a company's performance against plan and strategy and systems of risk management.

- c) Constructively challenge and question issues brought before the Board while working within a supportive framework. An adversarial approach is unlikely to improve the outcome of Board discussion.
 - d) Contribute to Board succession planning by the Nomination Committee, and also provide the members for the Audit and Remuneration Committees.
9. There should be a roughly equal balance of executives and non-executives on the Boards of large and medium sized companies, with the preference for a slight majority of non-executives. Smaller companies may have a lower proportion of non-executives.
10. Non-executive directors should be well informed about these different roles but cannot be expected to fulfil all of them.

3. How does this compare to the present position?

11. Non-executive directors are on occasion not sufficiently challenging and/or critical of executive management performance.
12. We prefer non-executive directors to work for improvement: resignation should be a matter of last resort.

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

13. This question highlights the need for substance rather than form although form cannot be ignored. Independence of mind and action, and integrity, are ultimately more important than theoretical conflicts of interest. Each case should be considered on its merits.
14. There are many circumstances where a useful contribution can be made by non-executive directors who could be regarded as not being independent.

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?

15. The main potential for conflicts of interest arises when management objectives are not aligned with those of shareholders, e.g. a listed company buyout, remuneration, and financial reporting.
16. A good Chairman should recognise the conflicts and can enhance non-executive director effectiveness by ensuring an appropriate balance in the debate. A good senior non-executive should perform this role if the Chairman is compromised by potential conflict.
17. In extremis, and only in extremis, non-executives may seek the support of shareholders. Such contact should only occur when there has been a breakdown in communication between the non-executive directors and their Board colleagues.

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?

18. A non-executive Chairman should commit between one and three days per week, depending upon the size of the company.

19. Non-executives might expect to spend between two and three days per month on the company's business, but this could increase if particular corporate issues or financial problems were to arise.

20. An executive director of a listed company should not be Chairman of another listed company.

21. As a general rule no individual director should have more than two Chairmanships of listed companies and where this applies not more than one other listed company non-executive appointment.

22. Beyond the above it is difficult to be prescriptive in this area.

23. A full-time executive director should be encouraged to have non-executive experience but should not have more than one listed company non-executive appointment.

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

24. Particular circumstances such as a combined Chairman and Chief Executive can make the role useful but it has little relevance when a Chairman without executive responsibilities performs his role effectively.

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?

25. If nothing is done by the Government to address the issue of non-executive director vulnerability to legal challenge, we anticipate that fewer candidates will be forthcoming for appointment as non-executive directors.

26. The proposed statutory statement of directors' duties is welcome, but fails to prevent directors being exposed personally to unfair legal action which pierces the corporate veil. Directors should not be so exposed when in good faith they have reasonably relied upon information provided to them. We would strongly prefer that there should be no distinction between the legal duties of executive and non-executive directors as such a distinction would undermine the effectiveness of the unitary Board.

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?

27. Non-executive directors on a Board should collectively have previous experience of both complementary and different types of company while providing a good mix of experience of financial, strategic and business management issues. The substance of their actual contribution is much more relevant than the form of their achievements elsewhere.

28. Non-executive directors should be able to contribute constructively to Board deliberations and in most circumstances should avoid taking an adversarial approach.

29. Membership of the Board's audit committee does give rise to a particular need for understanding of good financial management. It is not necessary for all members of the audit committee to be accountants so that issues can be tested by informed non-accountants, e.g. whether accounting policies are clear and appropriate.

30. Appointments can be facilitated by the Board's Nomination Committee planning future non-executive director succession on a phased basis. It is anticipated, however, that it will become progressively harder in future to recruit non-executive directors in the context of their exposure to an increasingly litigious environment.

10. What personal qualities and attributes are needed?

31. These would include independence of mind, experience relevant to the company's business and a constructive approach to Board discussion.

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.

32. Difficult to generalise, but should be company specific. (See answer to Q9.)

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?

33. The increasing perception of an unfair exposure to litigation is a worrying trend which may result in less scope to recruit future non-executive directors. It should be addressed by the Government within the proposed legal definition of a director's duties, whether executive or non-executive. (See answer to Q8.)

34. A properly constructed Board following due process can anticipate and plan for future appointments on a timely basis. Making appointments at a time of crisis is much more difficult.

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?

35. Board appointments should be on a meritocratic basis and cannot be regarded as a training course for candidates with inadequate relevant experience. Prior experience of the working of a company is essential.

36. The pool of available talent is progressively expanding as there is now much greater diversity of background amongst the ranks of company executives. It is from their number that most future Board non-executive appointments will be made, although increasing concern about directors' liability can be expected to discourage good candidates from seeking such appointments.

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?

37. Non-executive directors should not be financially dependent upon their remuneration but appropriate recognition of contributions suggests higher reward in some cases.

38. If the liability issue is not addressed as we suggest in our answer to Q8, significantly higher payments will be sought by non-executives. Restricting the number of appointments an individual director can hold will significantly impact market levels of payment.

39. Non-executive directors can be paid in cash or shares but share options, which are geared shares, possibly encouraging speculative activity, are unacceptable and inappropriate. There is, however, merit in companies mandating that all directors should maintain a shareholding.

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

40. The significant benefits of corporate limited liability are being threatened by litigation against individual directors which pierces the corporate veil. If nothing is done by Government we can expect increasingly limited insurance cover for directors combined with escalating cost of premiums for such cover as is available.

41. The answer to this issue should lie in the current review of company law. Government should address the issue by reviewing the definition of directors' duties; if nothing is done it will become increasingly difficult to find non-executive directors of suitable quality.

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?

42. The Combined Code is working well in practice both in terms of the balance on most Boards and the role of non-executive directors. Independence of mind and contribution to the Board in practice are more important than the perception of a possible conflict of interest. However, such perceptions can be unhelpful unless adequately explained, particularly when there has been a previous close working relationship between executive and non-executive directors. Having made that point, substance matters over form.

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?

43. Board committees are essential to facilitate governance and effective contribution.

44. Remuneration and Audit Committee membership should not include executive directors, although in the case of audit it is general practice for them to attend.

45. Nomination Committee membership should be non-executive but the Committee needs both executive and non-executive input.

46. Committees should have the power to appoint their own advisers, e.g. remuneration consultants.

47. Companies should ensure that all committees of the Board have comprehensive terms of reference.

48. There should be several executive directors with preferably a majority of non-executive directors for large companies and 16 could be a maximum number of directors. However, prescription is inappropriate and special circumstances could give rise to the need for a greater number.

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?

49. See our answer to Q17.

50. The appointment of auditors should be a recommendation by the Board as a whole and endorsed by shareholders at the AGM. The Audit Committees

should make a recommendation to the Board and that recommendation should be made after taking account of executive input.

51. Consideration should be given by an appropriate Review body to the definition of audit work and, for example, whether it should include regulatory reports, filings on overseas stock exchanges, due diligence and tax advice. Once a definition has been determined Audit Committees should then give clear guidance to the executive as to what forms of non-audit work will be permitted.
52. The Chairman of the Audit Committee must have an understanding of good financial management.
53. The company's internal auditor should have a dotted line report to the Chairman of the Audit Committee.
54. The members of the Audit Committee should meet with the external auditors and the internal auditors without any executive presence at least once per annum.

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

55. See above. Where the Remuneration Committee does not appoint specialist advisers it should approve the terms of reference for any consultants before management makes an appointment.
56. Nomination and Remuneration Committees do not always appear to be as challenging in company governance as they should be.

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?

57. The Chairman is responsible for the performance of the Board as a whole, and for assessing the performance of the non-executive directors and Chief Executive individually.
58. If circumstances arise when the Chairman ceases to enjoy the confidence of the majority of Board members the Nomination Committee should be empowered to find a successor.
59. The Chief Executive should be responsible for assessing the performance of individual executive directors.
60. See below.

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?

61. As performance of the Board is ultimately demonstrated by the performance of the company's business and capital in the markets it is difficult to envisage a better measure of performance.

62. Some Boards have been known to meet infrequently, and non-executive attendance at Board meetings should be disclosed in the company's Annual Report, as should the number of Board meetings held each year. Apart from that the performance of non-executive directors within a unitary Board structure should not be commented on publicly.

63. In any event, it would be difficult for non-executives to report on their achievements for the year because some of their successes might have been through preventing things happening which it would not be appropriate to make public, e.g. an aborted acquisition.

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?

64. A good Board should debate and challenge executive decisions, and non-executive director contribution to such debate should be encouraged by the Chairman.

65. The Chairman should ensure there is sufficient information and time for the Board to understand and debate the issues.

66. Non-executive directors are on occasion not sufficiently challenging and/or critical of executive management performance. We prefer non-executive directors to work for improvement: resignation should be a matter of last resort.

67. In extremis, and only in extremis, non-executives may seek the support of shareholders. Such contact should only occur when there has been a breakdown in communication between the non-executive directors and their Board colleagues.

68. See also our answer to Q3.

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?

69. Relationships between non-executive directors and shareholders are working reasonably well. As shareholders we welcome occasional contact and are confident that access is generally available when necessary.

70. Company Chairmen should be prepared both to respond positively to approaches from shareholders, and if necessary to take the initiative by approaching shareholders directly when particular circumstances merit such action.

71. The Myners suggestion that there should be annual structured meetings between shareholders and non-executives is not practical, and more varied contact is to be preferred.

72. Accountability for performance by the company and the impact this has on share price performance must lie with executive management. To prevent misunderstandings it is essential that this line of accountability is preserved and not blurred by random contact between shareholders and non-executives.

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?

73. See above.

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?

74. Within the context of a unitary Board non-executives should communicate with management via the Chief Executive (or where appropriate the Company Secretary) who should be aware of any dialogue which continues.

75. Communication with key external advisers should be with the knowledge of the Chief Executive. Otherwise chaos could result with varied accounts being given of the company's objectives and achievements.

76. As mentioned elsewhere, when serious problems exist different procedures should be available.

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

77. By working closely with the Chairman and Chief Executive and by supporting information flows both to the Board and to committees of the Board.

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?

78. Non-executive directors have a right of access to all levels of management to obtain information or clarification of information.

79. Non-executives should contact the Chief Executive (or where appropriate the Company Secretary) in order to inform them in advance of their request for information and to seek guidance as to the appropriate individual for them to

consult. In the event that a non-executive director considers he has received an unsatisfactory answer to his enquiry he should take the matter to the Chief Executive or the Chairman.

80. Non-executive directors rarely complain to institutional shareholders about lack of information and this may suggest that information flows are generally adequate.

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

81. The company should maintain an ongoing training and development programme for all directors, whether executive or non-executive. The aim of the programme should be to ensure that directors are informed of all new developments relevant to their role (and, by way of guidance, in particular the items covered in our answer to Q29 - Induction Programme) and also to ensure that they are sufficiently equipped to progress the ongoing development of the Group's businesses.

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

82. A good induction programme is essential, and arrangements can probably be improved. Potential non-executive directors should make contact with some of the company's larger shareholders as part of their due diligence.

83. Companies should tailor the induction programme to their business and to each individual director to reflect his or her own experience and might typically cover the following items:

- a) The group's principal businesses, products, assets and competitor analysis.
- b) The role of a director; duties and responsibilities.
- c) The company's constitution, group structure, significant contracts, joint ventures and strategic alliances.
- d) Corporate governance: the Board structure, committees, Board processes, conflicts of interest and ethics.
- e) Group financial structure and its management.
- f) Risk management processes.
- g) The group's accounts including unusual conventions or items.
- h) Remuneration policies including share schemes and incentive schemes.
- i) Current price sensitive projects.
- j) Group shareholders, principal advisers, recent market activity and analyst reports.

- k) Introduction to senior personnel, visits to main locations, introduction to products and processes.

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?

84. Probably not, but they should be supported by the Chairman who is responsible for assessing non-executive performance.

85. The performance of non-executive directors should be measured against appropriate criteria.

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?

86. Sometimes there may only be two non-executive directors although three is a better minimum, particularly when the roles of Chairman and Chief Executive are combined or large family shareholdings exist.

87. Institutional shareholders often have large shareholdings in smaller listed companies and consequently have more influence. In view of this the nature of dialogue between institutional shareholders and executive and non-executive directors will differ from that which takes place in larger companies.

88. In due course smaller listed companies should identify where they depart from best practice as identified by the outcome of this Review.

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?

89. The benefits of the UK true and fair test are that it requires judgement rather than prescription and box ticking which has proved to be ineffective elsewhere.

90. US Boards having one executive director are discredited and European two-tier Boards often fail to challenge executive director performance.

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

91. Currently the unitary Board structure of a UK listed company and the concept of non-executive directors does hold its own in an international context as being a good balance between owners and managers.

92. However, an increasingly prescriptive corporate governance regime and an increase in individual liability run the risk of wealth creators seeking opportunities in other corporate structures outside the listed market.

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

93. At this time UK arrangements appear to compare well with current alternatives but this should not preclude acceptance of better practice when it becomes recognised.

**Prudential plc
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