

The Higgs Review of the role and effectiveness of non-executive directors

Submission by The Strategic Partnership (London) Limited

6 September 2002

**The Strategic Partnership (London) Limited
2nd Floor, Berkeley Square House
Berkeley Square
London W1J 6BD**

**Telephone: +44 (0) 20 7872 5855
Fax +44 (0) 20 7701 1479
Email: p_smith@s-p-l.com**

The Strategic Partnership (London) Limited

SPL is a leader in the field of delivering value for businesses from their intangible assets, particularly their relationships. We work with organisations, using a range of proven initiatives, to help build appropriate levels of trust into each of their key stakeholder relationships to enhance value, minimise their cost of doing business and sustain their reputation.

Our approach is based on the growing awareness amongst business, government and the community at large that the prosperity of individual businesses is directly linked to the perceptions of the broader community. Earning the approval of the community in order to maintain a 'licence to operate' and to preserve the right to be heard is an important reality for businesses in today's world. Sustainable success for a business or organisation, therefore, depends on fully understanding the nature, the needs, the values and the expectations of all the key stakeholders on whom that success depends. Whether in generating revenue or containing costs, these relationships, and the way they are managed, are critical. That is what SPL assists its clients to do.

Consequently, Corporate Governance plays a critical part in SPL's work in that structures, accountabilities, and disclosure functions of Boards, and the increasing requirement for compliance with regulatory standards, have a significant impact on the way in which companies and organisations interact and manage relationships, with their key stakeholders. Although most of our work is for United Kingdom companies, including a number of leading investment institutions, an increasing amount is undertaken internationally..

Established in 1994, SPL is an independent, privately owned consulting firm dedicated to achieving results through high quality and innovative consulting approaches. Our 'virtual' structure – a small central core and extensive network of very senior level and diverse expertise - gives us the flexibility to match the best skills to client needs.

Although our solutions are highly practical, we are at the cutting edge of organizational and business thinking. An advisory board selected from leading international business schools provides both academic validation for our work and fresh research: intelligence which we share with our clients. The Board of SPL and the Academic Advisory Board are chaired by Professor John Stopford, Professor of International Business at London Business School.

Review of the role and effectiveness of non-executive directors

The Strategic Partnership (London) Ltd. sets out its commentary on the issues set out in the Consultative Paper 'Review of the role and effectiveness non-executive directors', being carried out by Derek Higgs.

Each suggested issue is stated in italic characters followed by our response and comments in bold type. On some issues additional points have been included and these are indicated in sub-headings.

This document has been prepared, on behalf of SPL, by Peter Smith, Chief Executive and Gavin Fryer, a member of SPL's Advisory Board and joint leader of its Corporate Governance Practice. Peter Smith is a former Chairman of the Investor Relations Society and Gavin Fryer is a former Director of Listing at the London Stock Exchange.

Introduction

This review of the role of non-executive directors is most timely in that it coincides with the consultation period of the White Paper, 'Modernising Company Law', key proposals of which at last negate the assertion that has been in place until now that there is an incompatibility between shareholder value and stakeholder value. In proposing that the duties and responsibilities of directors should be spelled out in a single accessible place, the White Paper distinguishes between "accountability to" and "accountability for" by making it clear that while directors are solely accountable to their companies, that accountability extends to conducting a company's relationships with all its key stakeholders.

The draft legislative provisions spelling out the duties of directors, set out in the White Paper, while not proposing any fundamental changes, inter alia:

- state that directors should have regard to the long term, as well as the short term, consequences of their actions; and
- highlight the company's need to foster its business relationships, to consider the impact of its operations on the communities affected and on the environment, and to maintain a reputation for high standards of business conduct.

The White Paper proposals are designed for a vastly different environment in which companies are required to operate in today from that which existed when the last major review of company law was undertaken in the 1980s. The modern company needs to be multi-purpose. It also needs to:

- permanently rejuvenate itself and keep its strategy and way of operating continuously under review, while operating in a fiercely competitive market at home and abroad;
- work with key suppliers to enhance both their outcomes;
- maintain a mix of employees and independent contractors, with a greater emphasis on networking rather than hierarchy;
- recognise that its skills are in constant need of renewal and redeployment;
- face the increasing pace of technological change; and
- value its knowledge and skills more than the capital tied up in its fixed assets.

All of this makes the tasks of company boards much more complex. The policies of corporate boards of directors receive far greater attention from the investment community, in corporate management and in the business media than at any time in the past. Furthermore, recent events in the UK and the US have resulted in a sharper focus on corporate governance, placing it at the forefront of the corporate agenda.

It is clear, therefore, that a fundamental shift in the role of the board is taking place. It has to act as an independent monitor of management, asking the tough questions that management might not ask itself. This needs to be done continually, not just in crisis situations, but also when the company is doing well. The role of the Non-Executive Director in these circumstances, therefore, becomes much more important than hitherto.

We believe, therefore, that there are some basic principles regarding the role of Non-Executive Directors which boards need to embrace that will enable them to function in a way that will meet their responsibilities best:

- **there should be a clear majority of non-executive (outside) directors.** We believe that the recommendations of the Combined Code in this respect no longer meet the requirements for true independence. It is quite clear that a board cannot function as an independent auditor of the company's management activities if the majority of its members are also members of the same management. In our view, inside (executive) directors are essentially pointless for governance purposes, because they simply are not in a position to speak out with independent insight about the company's or the management's activities.
- **the role of the 'lead director' as a facilitator of the governance process and the board's activities should assume greater focus.** In introducing the concept of the 'lead director', the Hampel Committee in 1998 did not imply that he/she should be 'first amongst equals' as every board member is equal. However, we believe that the role of the 'lead director' should be to provide

the non-executive directors with a different focus from the Chairman, when this is required and to chair periodic meetings of the non-executive directors and prepare the agenda for those meetings, leaving the Chairman free to concentrate on the bigger picture of Board management and direction.

- **in addition to the routine or formal meetings of the full Board, the non-executive directors should meet alone on a regular basis.** Such executive sessions, which should allow enough time to ensure full and deliberate discussions of the performance of the business and the management, can be important for coalescing the Board's interests and focusing its attention on specific areas or problems. By formally scheduling these meetings part of the board timetable, there is less chance that management will view them as a threat
- **The Non-Executive directors should take responsibility for making proposals for changes needed to the structure of the board.** The board, through having a clear majority of non-executive directors, should establish its own policies, practices and procedures. It should determine its size and its committee structure in line with the guidance set out in the Combined Code. With regard to board committees, we believe that these should comprise solely of non-executive directors. The board should also determine the time limits for each independent director and what the retirement age should be. It should also decide such matters as formats, time allocations and agendas of board meetings. Such decisions should serve the needs of the board, not management.
- **The board should have a process to review its known performance.** A board needs to determine systematically whether it is adequately monitoring management and providing effective advice to management. There should be an established process and specific criteria, including input from the Chief Executive. Such reviews should be of the board's performance as a whole, not that of individual directors - that is part of the role of the Chairman, on which we comment in the main body of this paper below. The review of the board's performance should include consideration of areas in which the board believes a better contribution could be made.
- **The Non-Executive directors should conduct regularly scheduled reviews of the Chief Executive's and key executives' performance.** These reviews should be based on established, objective criteria, including the performance of the business, the accomplishment of long-term strategic business objectives and the development of the company's management.

In advocating that directors should have more independence and should actively monitor management, we do not mean to suggest that they should have an adversarial relationship with management. Rather, it should be a sympathetic and productive relationships because the board has an important role in helping management succeed. Mutual respect

and trust between the directors and the Chief Executive are essential for a board to be productive. Strong boards consisting of directors who take their obligations seriously and work at their responsibilities should not be a threat to management. Quite the reverse. Strong boards can be a source of strength to management and, as such, can be a source of competitive advantage to a company. The board, as we argue below, is responsible for the successful perpetuation of the company. That responsibility cannot be relegated to management.

There is one important overriding aspect to the role of the Non-Executive Director which impacts on the way in which he/she is able to exercise his/her responsibilities and that concerns the number of non-executive positions that any one individual holds. In our view, no one can reasonably fulfill more than four such positions. We believe that such a limit should be included in the new Companies Act and that, certainly, in the meanwhile, the number of board positions already held should be an important criterion for Nomination Committees to take into account when considering potential Board candidates.

A: The role of the non-executive director

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

1. What is the role of the board?

The Board is responsible for everything that is done in the name of the company and for anything that is not done that should be done. The role of the Board is therefore to set the business strategy of the company and manage the fulfillment of the business objectives that enable realisation of that strategy. As part of their direction and management role the directors must set policies and issue instructions to ensure that the Board receives reports of what has been done, or is recommended to be done, enabling them to be fully informed to take decisions.

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

The Chairman is responsible for ensuring that the Board formulates a relevant and viable strategy. He is responsible for ensuring that proper arrangements for succession planning are in place. He must ensure that the Board deals with the company's affairs in a proper and effective manner. He acts as the key public face of the Board at shareholder and other general meetings and in public. The Chairman is also responsible for ensuring that arrangements are in place to identify candidates for the board and that appointment of NED's are truly independent with respect to the affairs of the company

He must strive to stand back from executive operations and decisions and be aware of circumstances that merit his involvement to resolve difficulties or disputes. He will also direct the Board to deliver on its responsibilities. He must secure good corporate governance and ensure the balance of the Board enables it to be effective and responsible in its work and that each director does make his or her contribution to Board effectiveness. The Chairman must ensure that all relevant matters requiring approval of the Board and at shareholder general meetings are presented to those meetings.

2. What should be the key roles of non-executive directors on the board and what should be the balance between the different components?

First and foremost, Non-Executive Directors (NED's) bring an independence of judgement to reach the proper decisions that the Board should take. They should bring skills and experience from business, professional, academic or other activity that will add value and depth of independent judgement to the deliberations of the Board. While it is not necessary for all NED's to have experience of the particular industry in which the company operates, it is important that a sufficient number of them do. To ensure a proper balance, the Board and its Nomination committee

should agree and keep under regular review the range of skills and expertise and the balance between them to enable the Board to be fully effective.

NED's should be totally independent and objective about any issue before the Board.

Within a board, should all non-executive directors be expected to fulfil each of the different roles?

Not necessarily. NED's may well sit on different committees, rather than trailing each other. NED's should be prepared to help the Board through various committees, and in particular the audit, remuneration and nomination committees and be available to serve on other working groups as required. They should also be prepared to contribute to development of the company's future strategy and to act as a cross-check on ideas that the executive directors bring from their closer involvement with the company's activities. Such contribution may well be most useful in individual discussion with executive directors so that all can be better prepared for subsequent Board meetings.

Each NED will bring particular talents that should be deployed as effectively as would be the case with the executive directors. Certain Board projects may be best carried out by a sub-committee including one or more NED's as would achieve the best output.

3. How does this compare to the present position?

The contribution made by each NED to the Board on which they sit varies significantly.

Many NED's play a significant role in the Boards of which they are members and in some instances they have no doubt brought about, or contributed to bringing about, significant changes to the way the Board conducts its work, and the overall effectiveness of the Board. Some have also played a pivotal role in achieving changes in the composition of the Board. This may have come about through the nomination committee's work as part of succession planning or related action.

However, many NED's only study the Board papers while travelling to the relevant meeting. This means that apart from a degree of 'pontification' at the meeting, little contribution is made that is of real value to the Board or the company and its business.

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

Independence should be defined as totally independent of the company, its executive directors and management and of the group's advisers and stakeholders. Stakeholders in this context should include major suppliers, customers and other

parties with whom the company may stand to gain or lose significant money or resources. The parent company, major shareholders, other group subsidiary companies or sub-parent companies and associated companies, auditors and other specialist advisors should also be included in this context.

Certainly, the NED's should be totally independent thus excluding retired executive directors, pensioners and holders of share options. These NED's should be able to take whatever decisions become necessary without any kind of 'steer' or skew based on an interest that they risk placing before the impartial judgement that they have to reach.

'Independence' is a more relevant term to describe the role of NED's than 'non-executive'. This will particularly apply to the senior NED and the chairman of the three key committees of the Board that involve the NED's, Audit, Remuneration, and Nomination committees.

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?

Conflicts of interest arise where a NED allows other relationships to compromise his independence. In this context providing professional fee-earning advice and arrangements or transactions by which resources will or may be transferred from or to the company are too often likely to give rise to conflict.

Key examples of this are where a NED provides advice in the capacity of lawyer, accountant, tax adviser, management consultant, investment banker, stockbroker, real estate valuer or financial adviser.

What can be done to help non-executive directors to be effective in relation to these conflicts?

Two key activities need to be taken to avoid situations involving conflict. The first is proper due diligence by the Nomination committee and the Board of the NED's background and connections. The second is to educate candidates for board position as well as current directors of the importance of continuing independence. This applies as much to the non-executive directors as well as the executive. The use of a growing number of independent consultants advising on NED appointments may be helpful in ensuring that opportunities for conflict to arise are kept to an absolute minimum.

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?

The Chairman should be able to devote at least one day per week to his role if the responsibilities of that position are to be honoured effectively and positively for the company. This role is too important for it to be a sinecure.

Non-executive directors should be expected to devote between four and six days per month for attendance at meetings of the Board and committees.

The role of non-executive directors {'added issue'}

The role of non-executive directors should be to ensure that the company is being effectively led by both the Chairman and the Chief Executive and to contribute to development of strategy. The NED's should check that there are effective governance and control processes to ensure that the company's strategy is being effectively implemented. Where appropriate, the NED's should challenge and probe the executive directors on the day-to-day implementation of strategy. In particular, NED's should take an active role in the Audit, Nomination and Remuneration committees of the Board, the membership of which, as we have stated above, should comprise only non-executive directors.

Are there any implications for the number of non-executive posts that one person can sensibly take on?

Yes. The number of boards to which any one individual can make an effective contribution is no more than four. Company law should limit the number of boards on which an individual can sit. It simply not effective for an individual to consider acting on 6, 8 or 10 boards of separate entities, let alone 28 in one instance.

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

Yes. The senior non-executive director, other than the Chairman, is responsible to the Board for the NED's work. He will be responsible for preparation of papers for the agenda and chair meetings of NED's. He should be available to the other NED's for discussion of matters of concern to them and similarly to shareholders and other stakeholders. He should prepare and sign an annual report on the work of the non-executive directors for inclusion in the company's annual report and this report should be agreed with the other NED's.

These points also apply specifically to the remuneration, audit and nomination committees. These reports need not be long unless there are particular points that need to be brought to the attention of shareholders.

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 company is an inanimate entity. All actions by the company are decided and actioned by one or more directors. The statement of directors' duties should include the provision that no director should be able to act on his or her own thus placing the responsibilities of the other directors at risk without a prior decision of the

board. All directors, whether executive or non-executive, share responsibility for every action or inaction, as well as mistakes or willful damage to the company and the interests of stakeholders.

The present position should continue whereby a director who has resigned should continue to be held accountable, as though a director, for the consequences of decisions and control exercised during his period in office, for a year after relinquishing the position of director. This should not in any way be diluted. All remaining directors whether executive or non-executive, will carry all responsibility for the company. This could mean that for a short period non-executive directors will have a major role until the executive proportion of the board is re-established.

The proposed statement of director's duties set out in the Company Law Reform Report commanded the widest support. We support the recommendations in the White Paper "Modernising Company Law" regarding the codification of directors' common law duties and believe that the draft statement of these duties provides clear and authoritative guidance to directors. The statement strikes the right balance between modern business needs and the wider expectations of today's business behaviour. The Audit committee performs an important role, a part of which is to ensure that there is a good working relationship between the company and the statutory auditor, but also for the internal audit processes, management of the internal control systems, management of the company's exposure to potential risk, and areas that could give rise to potential conflict of interest between any of the directors and the company.

It is important that the Board agrees and delegates a single conduit for communication to shareholders, the media and the securities market so that there is an orderly process for communication of information.

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?

The key skills and knowledge which NED's should possess are:

- **good interpersonal skills**
- **the ability to engender trust between fellow directors and themselves and senior management**
- **knowledge of company law is useful**
- **corporate governance, principles and good practice as well as the ability to identify pitfalls**
- **a good understanding of the nature of a director's responsibilities and duties**
- **be able to 'read' a balance sheet and profit and loss account**
- **Not be afraid of asking questions and probing where that may be necessary**

In addition, should a situation arise where all executive directors resign, or cease to fill their positions, the NED's must run the company. In such an event, NED's will be required to apply basic management skills.

The public perceptions of the role of NED's has changed fundamentally following the latest reported corporate failures in the UK and USA. NED's now have to recognise that no longer their role a sinecure.

Directors must now have a clear understanding of corporate risk, how their responsibilities should be exercised and the consequences of not doing so effectively. Detailed Regulations governing the activities of a company are likely to expand markedly and a full understanding of those will be necessary. That means that all directors should take time away from the company's operations to undergo some training on these issues.

This is not a question to be asked or a skill to be developed during the next year or ten years.

Are some skills essential and, if so, what are they?

NED's should have enquiring and open minds and be able to take a critical, yet dispassionate, view of behaviour and conduct as well as actual delivery of success and profit or enhancement of the entity's total funds and resources.

NED's should have direct access to the Chairman or the company secretary where the NED's have concerns.

10. What personal qualities and attributes are needed?

NED's should bring an independence of judgement, courage to take unpleasant decisions when necessary and to be able to speak out when conduct or other circumstances occur that merit such action. NED's must bring the highest integrity to bear upon the work of the Board. They should also have skills and experience relevant to the company's main activities, as well as experience of other work areas and disciplines that would enhance the comparative yardsticks that are or may in future be applied to the direction of the company's affairs.

NED's should have good inter-personal skills, some training in a professional discipline or industrial or commercial activity relevant to the company's business. They should have a 'sense of proportion', be able to 'see-the-wood-for-the-trees', and bring a balanced judgement to the Board's proceedings. A sense of humour would be desirable.

NED's must have sufficient time available to devote to their duties and responsibilities in each and every directorship they hold.

11. What sort of mix of experience and attributes is desirable on a Board?

In general, personal attributes like integrity and the ability to listen with an open mind are essential requirements for good board members. Equally important, however, are the willingness to engage in constructive discussion with other board members and the courage to make tough decisions. A mix of doers, achievers and thinkers would facilitate sharing of delegated duties. All directors must be able to see the other person's point of view in case their own perceived view is, on more mature consideration, incorrect. A director who 'goes-it-alone' may be successful, but all have to recognise that such a tactic is risky and before acting he must share his intentions with all members of the Board.

Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.

Sometimes the chief executive or chairman of a company has proved to be inadequate to the requirements and demands of today's business environment and

has had to be replaced. This takes courage and the initiative for such action would rest chiefly upon NED's.

12. How easy is it to recruit non-executive directors with the right skills and attributes?

It is not easy to recruit new candidates for the Board from existing pools of individuals who have skills and experience appropriate to the company's business activities and are wholly independent of the company.

The pool from which candidates for NED positions on Boards of directors is drawn is limited and needs to be widened. Too often this role is filled by individuals with little relevant experience or knowledge to facilitate the company's business but rather are long-standing friends of the Chairman. If that accounts for the seeming failure of non-executive directors to help prevent the worst instances of corporate accidents leading to corporate failure, the Boards concerned have only themselves to blame.

An important catchment area from which non-executive directors could be recruited is the senior management below board level of major corporations. This depends on the boards of such companies supporting their key management and seeing board experience for them as an important part of the career development for their senior managers. In order that this should not become abused or impair a manager's contribution to his/her employing company, it might be necessary to limit the number of directorships that a senior manager could take up to one or two.

The increasing number of people taking early retirement or deciding to undertake 'portfolio' lives too offers an increasing pool of people who should be considered for non-executive appointments.

Furthermore, too few boards or senior managements have adequate representation by women or ethnic minorities, as has become frequent practice in the USA. There is a considerable pool of talent amongst such groups who also merit greater attention by Nomination Committees.

Could recruitment and appointment mechanisms, including Nomination Committees, be improved?

The Nomination committee should make enquiries outside the company about the candidates for nomination as NED's or executive directors. The NED's may need to look to other company boards for individuals who may be released for service as a NED.

All NED's have to earn the respect of their board colleagues. However, prior to appointment, candidates for NED position should carry out their own due diligence on the company and its directors with whom they will be sharing responsibility for the company's affairs and satisfy themselves how well the company is managed.

NED's should examine:

- **the company's annual report and accounts and simplified annual statements;**
- **recent information published by the company including half-yearly or quarterly reports and circulars;**
- **press comment;**
- **analysts' reviews;**
- **published information about the other board members; and**
- **other published information.**

Candidates must ensure that they understand the principles and specific provisions included in the codification of directors' duties in company law and how wide their responsibilities are in fact.

No NED should serve on a single company's Board for more than 10 years, including a year on probation, and usually two but no more than three three-year appointments.

Reporting on appointments and performance { added issue }

We believe that there needs to be greater transparency in the appointment of Non-Executive Directors. The company's annual report should include a statement about selection and appointment of NED's including the following aspects:

- **the processes and methodologies for selection of candidates;**
- **the way by which candidates were selected;**
- **what due diligence and other enquiries were carried out;**
- **how the Board decided on suitability of the candidate(s);**
- **what factors were taken into account in the Board's discussion;**
- **whether the decision of the Board was unanimous and, if not, include an explanation of why the appointment was made against the votes expressed by one or more members of the Board; and**

with regard to performance of all directors a statement:

- **as to how the Board members' performance is reviewed;**
- **the result of such review;**
- **the length of service and periods of service of each member of the Board;**
- **the periods for which each director was appointed and the date on which the present appointment of each ends.**

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?

The pool of NED's should draw on skilled experienced individuals who may not already hold a position of NED but have been working as an executive director or senior member of the management team in say a plc or large private enterprise. A good number of such individuals could be released to take up one NED directorship in a company that is not a competitor to their own. An additional source may be drawn from people active in other disciplines, such as academia, so long as their experience and knowledge is relevant to the company's interests.

For example, an executive director or senior manager of a plc should be able to make time for one plc NED appointment and still be able to honour his responsibilities with the company to which he is mainly accountable. That would potentially provide a pool of 20,000 individuals.

Is there scope for greater international representation on UK boards?

Increasing globalisation means that those companies that have international activities should have some NED's on the Board who are nationals of the key territories in which the company operates and who can bring a wider perspective to the Board's deliberations. Such directors will, however, need to be fully aware of their general responsibilities under UK company law and will need to ensure that they understand how those provisions are applied in practice.

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?

In most cases the rewards for NED's are inappropriate. NED's should not be remunerated in any way that compromises, or could later compromise, their independence. In fact, quite the reverse. If NED's wish to enjoy the success of the company as reflected in the share price, they should be enjoined to purchase shares when being appointed. Such purchases would have to be carried out in accordance with the requisite code for directors' share dealings.

NED's should not either receive or be entitled to receive share options as remuneration. In other respects, their remuneration should reflect the time involved in preparing for and attending Board and committee meetings at full comparable market daily rates paid to the company's professional advisers.

Are current pay levels a significant factor in whether good non-executive directors can be attracted?

'Yes. In addition to the points made above, NED's by and large are not paid a sufficient fee to reflect the time devoted to their duties on the Board and in board committees or on board project work. A recent survey of FTSE directors supported

the view that NED fees should be higher and that consultants' daily rates represent an appropriate indicator of per diem rates.

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

Yes. The company should take out directors' and officers' liability insurance cover for all directors including the NED's who should be covered for the same risks as the executive directors given the responsibilities that they all share.

NED's should have access to independent legal, accounting and other relevant specialist advice paid for by the company. They may be best advised by different firms of advisers, or at least different partners.

No NED should have more than say 4 such directorships of plc's if he or she is to provide the time and resources to fulfil these roles effectively. Public expectations are growing markedly and each holder of NED position should feel that the pressure to perform effectively is just as transparent as with executive directors. Candidates should take account of other non-plc appointments such as pension fund trustee, university or school governor, a seat on a hospital management committee or charity trustee or other active committee work.

Review and rotation of NED's {'added issue'}

NED's should be appointed initially for one year at the end of which their performance and contribution would be reviewed by a sub-committee comprising the Chairman, the lead non-executive director and the chairman of the Nomination Committee. If satisfactory, the NED should be appointed for terms of three years, for a maximum of three such periods, or nine years. However, their re-election at the end of each three-year period should not be automatic, but subject to performance review. (See also under "Reporting on appointments and performance" at section 12 above.)

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?

While the Combined Code may be said to have been implemented in most plc's, the degree to which it has been effectively applied varies considerably. In many cases it would appear that lip service is paid to the Code. There are independent consultants who are increasingly helping companies towards an impartial check of the application of the Combined Code.

In particular, how are the provisions on the balance between executive and non-executive directors and the role of independent non-executive directors working?

The Combined Code recommends a weighted balance in favour of NED's which we believe is right, but there should be sufficient representation of management on the board, particularly the Chief Executive, Chief Financial Officer and Chief Operating Officer.

Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?

No. This issue is related to the 'pool' of suitable candidates. See comments at sections 12 and 13 above.

17. Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors?

If the audit committee's terms of reference are specified and not limited to 'audit' matters and the NED's have access to the Chairman or company secretary, as discussed at section 22 below, then the present structures as adapted by Boards to their individual circumstances should work effectively.

Are board meeting procedures working effectively?

This issue is an important one. It was evident from a number of DTI Inspectors reports in past years that 'Board procedures' was one of the central issues that led to failure of the 'command system' in companies and failure of the company. Only an internal check carried out in conjunction with the Board, the chairman and company secretary would show how effective any Board had been. There are independent consultants who have the experience to make such assessments and advise the Board as a whole on how they can help themselves to a more effective management of the Board's activity and deliberations.

Do you have comments on board size?

The board of a plc should be between 8 and 15 individuals including NED's depending on the size of the company and to achieve a diversity of desirable experience and backgrounds. If the size were to be larger, there is less likelihood of all members of the Board attending meetings. All directors should regard Board meetings as the most important commitment of any board appointment. Furthermore between 8 and 12 individuals are able to express their views at a meeting and gain a proportion of available 'air time'. Members of larger groups will have difficulty in making an effective contribution to Board deliberations. This difficulty is likely to increase as the size of the Board increases.

Boards must have a weighting in favour of NED's, and preferably a majority of the directors. This has an impact on the availability of sufficient candidates for the position of NED's of the stature, experience and independence for such a role.

18. Do you have comments on the composition and duties of Audit Committees?

The Audit Committee should comprise only non-executive directors. This is too important an issue for the opinions that may have to be expressed by NED's on such a committee being compromised by the presence of executive directors. Meetings of the full Board will be the place for all to become involved in discussion of the findings of the Audit Committee.

How effectively are Audit Committees working in practice?

Not very effective as their scope is too often narrowly drawn. The responsibilities of the Audit committee should encompass wider oversight. This issue is addressed below.

Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?

Audit committee should include within its terms of reference a range of aspects of the management of the company, not only audit related. Examples are:

- **internal audit**
- **internal control systems**
- **management of risk**
- **financial resources and financial stability and control**
- **strategy, management succession planning, budgetary control**
- **recommendation on the appointment or dismissal of auditors**

The Audit committee should address shareholders in a separate report included in the statutory annual report and accounts. Such a report should be short enough to be included in any abbreviated report and accounts made available to shareholders.

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

Both the Nomination and Remuneration committees should be composed of NED's, who should be accountable to the Board as a whole. The chairmen of these committees should have ready access to the Chairman of the company and ensure that a short report on their respective activities is included in the company's statutory annual report and accounts.

The focus on directors' remuneration has brought the Remuneration committee into greater prominence. External advice should be available as appropriate to ensure that directors' pay is comparable with other companies, especially those operating within the same or similar industry as the company. Where advisers are retained, the Remuneration Committee should be the client, not the Human Resources Director.

Account should also be taken of some of the reputation issues surrounding 'pay'. While it is for each Board to decide upon the pay of its members, all directors should be prepared to explain at a shareholders' general meeting and to the media the reasons that justify their action in approving the remuneration package for any single director. If they are not prepared to do so in public then the question they must first ask is why they should approve the pay proposal.

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?

The Board should have a process to review its own performance as a whole and the performance of each member of the Board. It needs to determine a systematic process for monitoring management's actions. To do this effectively, the Board should agree a set of objectives and targets and the process by which the annual review should take place, including some input from the Chief Executive and a review of areas to which each director can make a better contribution to the company's affairs. The objectives and criteria for such assessment should be agreed by the Board at the outset.

21. Could more be done to review performance?

Yes. All directors should be the subject of review, including the Chairman and NED's. (see comment at 20 above on the review process)

Should more information on board performance be reported to shareholders?

Yes. The Board should include in the Annual Report a statement on the outcome of the performance review that it should conduct on itself each year.

Should companies provide more information on the performance of non-executive directors?

NED's should not be treated in any different way, save that the Chairman, the senior NED and the chairman of the Nomination Committee should carry out such review. Each director, whether executive or NED, should be the subject of a review of their performance and contribution to the affairs of the company.

22. Are non-executive directors able successfully to challenge executive decisions or expose serious problems?

It is probably true to say that not nearly enough questions have been asked by NED's until recently about conduct and behaviour as well as the effectiveness of the executive directors and officers of the company. Whether Board meetings are the most appropriate context in which to raise such issues is doubtful. In the first instance, such doubts or criticisms should be taken up by NED's with the Chairman of the company. Then the matters can be brought to the Board meeting with some remedial steps in contemplation by then. Otherwise a vacuum may well be created with little achieved and that opportunity may be lost.

Should it be made easier for them to do so and, if so, how?

NED's should have ready access to the chairman or the company secretary or the senior NED so that their concerns and views as well as recommendations are considered. The issues that cannot easily be dealt with must come before the Board and the Chairman and company secretary have a role to play to see that this is done with due deliberation and that adequate time is given to issues or concerns.

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?

In some companies these processes of communication work well. Relationships with each group of stakeholders rely on good effective communication. That does mean that quality not quantity should be the arbiter of how much to disseminate. However, in many instances neither the Board as a whole nor individual directors have the experience to distinguish or perceive what might be the impact of not keeping shareholders and all other stakeholders fully informed. To publicise more rather than less will in the end serve the company best.

Again, there are independent consultants who have more experience than individual PR firms of what should be done and where the pitfalls lie.

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?

There should be no barrier to access to NEDs by institutional shareholders, who should be encouraged to talk to institutions when appropriate. However, it is important that where that happens they do so in consultation with the Chairman and the Investor Relations Director. This should be a subject for regular review at the meetings of NEDs and it may be that institutional investors are invited from time to time to attend NED meetings. However, such meetings would have to be conducted in accordance with the Code of Market Conduct.

24. To what extent are Chairmen creating the conditions for non-executive directors to be effective?

'Old Boy Pals Act' used to be the basis for appointment of NED's. Now Boards appreciate, or should do so, that NED's can play a real role in the company that can contribute to the financial bottom line or net pre-tax result and, therefore, should be selected and appointed in a disciplined and objective manner through a properly constituted Nomination Committee. Conditions should be created whereby NED's are able to become fully informed and perform effectively. After all, NED's hold shared responsibility with the executive directors and it is in the latter's interest to ensure that their Board colleagues make the best and most relevant contribution.

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?

NED's must have access to such Board papers and supporting data and explanations as is available to any director. NED's should not be afraid of challenging perceived 'truths' within the company and ensuring that issues that ought to be discussed are not 'brushed under the carpet'.

25. What should be the relationship between non-executive directors and executive directors, and with senior management?

NED's should be regarded as members of the Board team and be treated with both confidence and respect. Unless this is so, NED's would be wasting their own and everyone else's time. NED's need good interpersonal skills that allow for good communication between fellow board members and senior management without the executive feeling that the NED's are really a nuisance to be disposed of in the shortest period of time.

What should their relationship be with the Chairman and the Chief Executive?

It is vital that the relationship between the Chairman, the Chief Executive and the NED's is of the best. Both the Chairman and the Chief Executive must make time available to explain matters not properly understood to a NED and, also, to listen to and understand points that the NED may wish to make that are perfectly valid. Trust on both sides is necessary, without which the relationship is likely to breakdown sometime.

The Chairman, in consultation with the Chief Executive, should ensure the quality of the processes of the Board, the agenda for meetings and preparation of the papers to be circulated beforehand. The Company Secretary is a facilitator and conduit for effective working of the Board and represents its 'compliance officer', making sure that the company complies with relevant laws and regulations.

What should their relationship be with key advisers to the company?

Arms-length professional and applying an ability to take an independent view, not necessarily to agree with the status quo and to question without seeming to undertake an inquisition into the routine.

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

The company secretary should be regarded as the Chairman's 'eyes and ears' on the management of the company. But the company secretary should be independent of the other members of the management team. He should not be beholden to the

entire Board for everything, but to the Chairman, for example where a problem that needs to be dealt with at a forthcoming Board meeting should not necessarily become general knowledge until then. The company secretary can only perform his role effectively where he has access at all times to all relevant documents and information or explanations within the company.

It is essential that NED's have access to the company secretariat for support for their role questions and comment from NED's, *inter alia*, advising them and acting as compliance officer in relation to any matter relevant to the company's affairs. This may involve some quite basic training needs that can either be satisfied within the secretariat or ought to be made available by the company from third parties for one of the NED's who has a need for it.

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?

Access should be complete. In any instance only 'top-level' papers will be necessary but if something needs to be looked into, NED's should have the same access to documents and explanations as any other directors, All directors share in the same level of responsibility.

In practice, are information flows and communication channels sufficiently open and unrestricted?

Where access is restricted doubt and further enquiry will be aroused.

Better to adopt an 'open-door' policy.

In the case of scientific processes and patents there may be a need to maintain some limitation on circulation of data.

But take the case of arms supply to Iraq as pipes. NED's in such a situation need to be able to have access to relevant information to be able to judge whether the Board has taken all the risks and circumstances into account in arriving at their decision to export such products to the customer.

28. What training and development opportunities are available?

More training opportunities have to be provided, even though that is at a cost to the company. In the long run such expenditure will be 'worth its weight in gold'. The more access NED's have to the company's policies, methods and practice, the greater the contribution they can make, including their and the company's development.

Could they be improved and, if so, how?

Examples might include:

- **Input from advisers to the company;**
- **Advisory sessions with external independent consultants or organisations on aspects relevant to the problems of the company or its lack of skills;**
- **Board sessions outside structured Board meetings at which additional know-how can be brought to the Board. For example, through the conduct of workshops with the directors to help them to develop stronger Board procedures and recognise aspects on which the Board has to improve its processes or techniques.**

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

It is essential that sufficient time and contribution by executive management is devoted to full induction of a new director, whether executive or NED, and even for existing directors who had not appreciated that changes had gone on around them of which they were blissfully unaware; for example new cash management system, or new production 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?

In many cases this can only be measured by an assessment through interviews of the individuals and others with whom they relate, by independent experts who can be instructed to re-assess the relevance and viability of existing procedures for determining clearly what is expected of NED, setting personal objectives, measuring performance and ensuring that the results are shared with the individual director.

This does not only apply to NED's but to all directors including the Chairman.

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?

The principles enunciated in our evidence are, we believe equally appropriate for smaller listed companies. However, they may be implemented in different ways to larger companies, to reflect both their size and the resources available. This particularly applies to those small companies which have securities listed where their responsibilities to the market and the public are the same as for larger companies. In essence all listed companies should adopt the same set of principles and, despite the relative cost in time and other ways, must do all they can to achieve proper management of their company.

The investing public are just as likely to find that shareholders' funds in small companies are as much in jeopardy as in a larger company. It may be best for smaller companies, say with a market capitalisation under £10m, to have only two NED's on their Board. This will be at a cost but would be manageable and the benefits may well be worth far more. For such companies to have only one NED would risk rendering his independence against a strong-willed executive chairman who does not accept the presence of NED's.

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?*

The US experience suggests that even with MBA's spread throughout management there, corporate failures are as widespread as in the UK. Many large companies are placed in Chapter 11 proceedings. Studies show that less than 40% of directors on US boards have had either a professional training, board experience, have attended a business school, such as Harvard, or even hold an MBA. The other 60%, or more, have no such qualifications.

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

There is increasing pressure from the European Community, in its attempts to standardize company law, to recognize the two separate functions of management and supervision. In some member states of the European Union this is formalized as a two-tier board structure. However, this is being questioned as, increasingly, more and more incidents of lack of proper supervision by supervisory boards come to light. This has led to increasing consideration being given to the UK and US unitary board structure, with the importance of the role of the non-executive director being increasingly recognized. On this basis, therefore, we do not believe that other models of corporate governance would contribute any more effectively to company performance.

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

We think not. If the UK system cannot be made to work effectively, what likelihood is there of British directors making any other practice more effective. We believe that the tools for effective governance and, therefore, effective performance, are already broadly in place in the United Kingdom. However, they need tightening and making more mandatory in a number of areas as we have indicated above.

-end-