

THE CHAIRMEN'S FORUM

REVIEW OF THE ROLE AND EFFECTIVENESS OF THE NON-EXECUTIVE DIRECTOR

1 INTRODUCTION

The Chairmen's Forum is an organisation providing the opportunity for Company Chairmen to share experience and ideas, participate in training programmes and influence decision makers. The Forum seeks to identify best practice in all areas that concern Chairmen and their Boards. This report reflects the views of a study group comprising senior members of the Chairmen's Forum.

2 THE ESSENTIALS OF THE REVIEW

This review of Non-Executive Directors (NEDs) generally refers to those acting for medium sized/large companies. Although all companies must observe the law in terms of corporate governance, there can be a significant difference in terms of corporate governance for small/private companies, and the main differences have been highlighted in this report.

The guiding principles of our review are set out below.

The understanding that the Board is the pacemaker and has ultimate responsibility for the success of the Company is fundamental to the review.

The Chairman's role and the manner in which he carries out his role will provide the opportunity or otherwise for a successful Board.

NEDs need to be clear about their roles within the Company and the important balance between being a contributor of wide experience and the fundamental role of ensuring best practice and good corporate governance.

NEDs should have a full constructive relationship with the Chairman and Executive Directors, and understand the views and expectations of shareholders.

The importance of independence or non-conflict of interest is essential for NEDs as well as the ability to devote enough of their time.

Key skills, required experience and personal qualities should be clear in the Board's mind before making NED appointments.

There is a need for a larger, trained and properly remunerated pool of NEDs and enhanced selection and appointment processes.

The Combined Code is well designed but it is essential that NEDs ensure that governance standards reflect substance over form, and their performance and communication is critical to good governance.

The Unitary Board is the most effective board structure, but it will only be successful with appropriately skilled and independent NEDs.

3 RECOMMENDATIONS

Role

- 3.1 A wide debate and recommendations on the role of NEDs particularly against the background of recent events and the Higgs Report.
- 3.2 A more significant biography in the Annual Report on individual NEDs and in particular the skills they bring to the Company. The role they will play in the Board structure, in particular chairmanship or membership of committees. (Noting the selection, induction and review process for NEDs within the company).
- 3.3 The appointment of a Senior Non-Executive Director, importantly not seen as competitive but supportive to the Chairman.
- 3.4 The Auditors should report annually on the independence of the NEDs utilising an appropriate standard.
- 3.5 Recommendations should be made on the maximum number of Chairmanships/Non-Executive Directorships held by an individual.
- 3.6 A clear specification of NEDs' duties (3.2 above) to clarify the position in terms of directors' liability, recognising that ultimately there cannot be a distinction between directors' legal duties but negligence is appropriately judged against the position, responsibilities and skills of a particular director.

Attracting and Appointing Non-Executives

- 3.7 A campaign to encourage and provide suitable candidates for Non-Executive Directorships. Encourage their training and development and improve the processes of appointment. Government/Institutional funding to support this process and appropriate organisations should be suitably 'branded'. Disclosure on appointment of the NED's commitment to training and development.
- 3.8 Following recent high profile corporate failures, the risk/reward ratio factor has changed dramatically. Remuneration of NEDs should reflect an appropriate risk/reward ratio but, at the same time, reflect independence. Unless this is recognised, the potential quality will be significantly eroded.
- 3.9 Boards should be as small as possible but there should be a concentration on the appropriate balance of directors.
- 3.10 Board Committees (Audit, Nomination and Remuneration) should be chaired by an appropriate NED. It may be appropriate for an outside expert not on the board to join the Audit Committee.
- 3.11 The Audit Committee is critical to the governance and confidence of shareholders. The following issues are essential for the Committee in addition to current responsibilities:
 - Recommendation to the Board on the appointment or reappointment of Auditors.

- Review the risk management process
 - Approve any other work carried out by Auditors to prevent conflict of interest.
 - A Committee Report signed by the Chairman of the Committee on the main issues covered in the year to be included in the Annual Report
- 3.12 The Annual Report should also include signed reports from the Chairmen of the Nomination and Remuneration Committees.
- 3.13 Significant remuneration policy changes, in particular new or materially changed share option schemes, should be put to the AGM.
- 3.14 Severance pay compensation, at least in part, should be linked to share price performance as recommended in the Myners Report.
- 3.15 Chairmen should report on the internal annual review of Board performance in the Annual Report.

Structures and Accountability

- 3.16 On the resignation of an NED on a point of principle, the Company should announce the reason.
- 3.17 Improved information on shareholding should be made available covering names of shareholders comprising 50% and the levels of communication with this group.
- 3.18 Company Secretary's role to be formalised in corporate governance and the relationship with the NEDs.

4 THE CHAIRMEN'S FORUM REVIEW

A. Role

1(a) The Role of the Board

The Board is responsible for the success of the Company and through this the satisfaction of the interests of the shareholders, employees and other stakeholders.

The Board is the pacemaker and will determine the strategic objectives and culture of the Company and properly evaluate and report on the success and record. Specifically, the responsibilities are listed as follows:

- The strategic objectives and policies
- The agreement of the annual budgets to secure achievement of the strategic objectives.
- The appointment of senior executive directors and satisfaction with the senior executive team.
- Monitoring and review of corporate and personal performance through appropriate reporting and information.

- Appropriate procedural and necessary authorities for board approval of capital expenditure and acquisitions.
- The highest standards of governance including appropriate use of Audit, Remuneration and Nomination Committees and non-executive directors.
- Satisfactory risk management procedures.
- Relationships, communication with and satisfaction of stakeholders.
- Review of the board's own performance.

1(b) The Role of Chairman

The roles of chairman and chief executive should be separate and, indeed, the roles are quite different. The board will look to the chief executive to ensure executive leadership and deliver results for the company shareholders. They may bring different approaches but they must agree on strategy, share the same fundamental beliefs and be professionally compatible

The role of chairman is a personal one to meet the necessary requirements and needs of the company and executive team. Nevertheless, there are certain fundamentals which all chairmen will require to meet.

- Leadership is the key, and the ability to get the best out of the board.
- A fundamental is meshing the qualities of the executive and non-executive directors in delivering success for the company.
- The unitary board remains the best structure for an effective board but places a significant demand on the skills and abilities of the chairman.
- The chairman, with the Nomination Committee, has a key responsibility in selection of appropriate non-executive directors to ensure they provide effective corporate governance and positive support to the company's success by providing wider experience and the alternative view.
- The chairman must ensure the board agenda's structure enables NEDs to be adequately involved and board committees provide appropriate forums for the NEDs to carry out their responsibilities.
- Together with the NEDs, he must review the performance of the chief executive and senior directors and, if necessary, take the appropriate action. This review may extend to senior executives not on the board particularly in smaller companies.
- The chairman should ensure that new NEDs spend time getting to know the operations and people within the company to ensure a full contribution to the board debate. Each year, the chairman should meet with each NED separately to discuss the board and relative contribution of the individuals.
- There should be a quarterly meeting of NEDs with the chairman.
- The chairman should create the necessary culture of trust and openness in the company – a full responsibility of the board.

2. Key Roles of the NEDs

All directors, including NEDs, must share the Board responsibilities as outlined above. NEDs will, in particular, need:

- to be satisfied with the company strategy
- to have confidence in the executive process and monitor performance of executive directors.
- to have confidence in the control and financial reporting processes
- to challenge and approve the programmes of acquisition and capital investment

This will require time to be spent by them in the executive process and with senior executives. NEDs require to have appropriate management or business experience to bring a wider and second opinion in the decision making process.

The key committees of corporate governance are the Audit Committee, the Remuneration and Nomination Committees. They should be regarded as fundamental arenas for NEDs.

The NEDs contribution is split equally between a contribution of wider experience and the responsibilities of best practice and corporate governance. At the end of the day, the second contribution is fundamental to their role.

Board Balance

The importance of an effective chairman is essential to the success of the Board. Weak chairmanship will lead to either significant under-performance or disaster in the short/medium term. Chairmen can stay too long and do not plan for their succession. The NEDs have a key responsibility for this and for the review of the chief executive.

The company chairman and chairman of the audit committee must have a special relationship with the finance director and have an effective line of communication. As well as successful executive management, the finance director must maintain the financial integrity of the company and ensuring that this is effective must be a key responsibility of the NEDs and in particular the Audit Committee.

NEDs should constitute around 50% of the board. An appropriate mix is required, both in skills and background.

A good financial background and experience is required for at least one NED and collectively they must have a mix of age and experience.

At least one NED should be capable of standing in for the chairman in the short term both in terms of experience and compatible corporate culture. This may be reflected in the nomination of a senior NED but he should not be seen as competitive to the chairman.

Stakeholder representatives such as bank/employee directors should not be appointed as board members – it is not appropriate to a unitary board.

3. The Present Position

The present position covers a wide range, but in a number of companies:

- The role and review of NEDs is not discussed
- NEDs do not make adequate contribution to the board
- Courage, in the form of challenge to strong characters, which is fundamental for successful NEDs, is not always exhibited
- Induction programmes and personal reviews do not take place
- The mix of skills is not appropriate to the company
- Little training and development takes place in the world of NEDs
- Pressure has been created by high levels of investor expectation and undue optimism in the market.

4. NEDs Independence

Neither in company law nor corporate governance has independence been defined. It is clear in a number of recent cases that the closeness of chairman and CE has been a weakness to proper independence. It might be unrealistic to legislate for the total independence of the chairman. However, the independence of each NED (and the chairman) should be tested rigorously and reported on by the audit committee.

5. Conflicts of Interest

Typical conflicts of interest include:

- Personal ambition for short term success or ego
- Remuneration packages requiring good short term performance but not sustainable performance in stock market terms

The remuneration committee has a full role to play in ensuring that reward reflects medium term, sustainable performance. The audit committee has a full role to play in terms of published results and NEDs should be aware of market expectation.

NEDs should have a counselling role with executive management. All interests should be disclosed and any conflicting areas fully discussed.

6. Time Commitment

In the largest companies, particularly multi-national companies, the chairman may be full time. Normally, chairmen spend between 2-4 days a week depending on size of company. In terms of the largest companies, it is demanding to carry out more than one chairmanship, and in other public companies not more than two.

NEDs will have to attend at least ten board meetings and 3-4 meetings of committees. Board meetings should be held away from head office around four times a year, including an away-day to discuss corporate strategy – overseas subsidiaries will introduce a further dimension. Reading, preparing and informal meetings means that in a normal year between 26-30 days will be spent on a company. It is crucial that NEDs are available on short notice to deal with unforeseen events which can be very time demanding.

The appropriate maximum number of positions is considered to be:

	Larger Companies	Other Companies
Chairmanship	1 + 3 NEDs	2 + 3NEDs
NEDs	5	7

7. Senior Independent Directors

There should be a senior independent director – his role is discussed above.

8. Directors' Duties

There must be no distinction between the legal duties of executive and non-executive directors. This principle is fundamental to the unitary board. However, individual negligence is appropriately judged against the position, responsibilities and skills of the director.

B. Attracting and appointing non-executives

9. Key Skills

There is the danger of 'one coat fits all' thinking when listing the specific skills of an NED. It is important that an individual is appointed because he brings professional or experience skills that are incremental to the existing Board. On appointment, it would be helpful if these skills are covered within the Annual Report.

The NEDs should include individuals with experience and expertise in:

- Accounting/financial reporting (often an ex-finance director)
- Up to date views on markets and technologies (often an NED holding a CEO position in a non-competing company)
- Personal/human skills
- Development markets (often overseas development)
- Experience in, and focussing on, creating shareholder value

In a business world of rapid change in markets/technology, it is important to have NEDs with up to date experience but also an NED with a pedigree of significant and wide experience built up over a successful career.

In multi-national companies it is helpful to have an NED who has business, cultural and political knowledge of the relevant geographic area.

10. Personal qualities and attributes:

- Independence of thought
- Integrity
- Courage
- Communication
- Patience
- Judgement
- Staying power
- Financial independence

11. Experience and Attributes

It is important to have a mix of experience and attributes to provide corporate governance and add to the board expertise and judgment. Certainly, accounting/financial reporting should be represented, up to date business/CEO experience, and relevant global market experience to provide a wide spectrum of experience.

12. Recruitment of NEDs

There is a significant reservoir of potential NEDs, but often an NED's career is only considered on retiring from a full executive position. Appointments, particularly in larger companies, tend to be made from a 'pool' of names who have a wide portfolio of directorships and, although of good potential quality, can bring a 'sameness' to the role and do not exploit the full potential of individuals available. Training is required for NEDs and a wider, more open selection process.

Professional search firms can prefer emphasis on remunerative executive appointments and there is probably a requirement for more specialist NED appointment firms.

13. Wider Pool

The potential pool is large enough, but requires specialist search firms, chairmen and nomination committees to look outside the normal sources. The pool of NEDs should be widened to include NEDs particularly bringing up to date market/trading experience within a company's development and growth market places, and chairmen should encourage their Chief Executive to hold one NED in a non-competitive sector.

14. Rewards for NEDs

The level of remuneration of NEDs should reflect the size and complexity of the company concerned. The level will be related to the level of salary awarded to executive directors. NED fees should be around 10 to 15 percent of CE salary but not normally less than £25,000. In small market capitalisation companies it may be less. In order to add a greater professionalism to the audit/remuneration committee, it could be appropriate to pay separate fees for committee work, in particular chairing the board committees. It is important that there is the right balance between reward, risk and independence.

NEDs should be rewarded by a cash fee. A significant shareholding could be detrimental to independence. Pay levels can be a significant factor in attracting NEDs.

15. Insurance Cover

Insurance cover should be provided for NEDs on a similar basis to executive directors, particularly against the background of a litigious society.

C. Structure and Accountability

16. Combined Code

The Combined Code is well designed and structured and reflects the principle that directors of public companies should run the company in the best long term interests of the shareholders. The recommended standards are clear but not prescriptive. The requirement is to disclose and justify departures from the standards. In practice, the Code has been increasingly better observed but it should be a key feature in considering the effectiveness of the board and the signing of the Report and Accounts.

Independence is generally well observed and these are key points:

- No business/ownership/family link
- No representation of major interest groups
- No options/incentives
- No executive remuneration or fees
- No direct management role
- Service limited to 10 years and directors should not be over 70 except with the approval of the Board

It is important there is a proper balance between executive and non-executive directors and no domination by a particular group – NEDs to reflect one-third but not more than one-half of the board.

17. Board Composition and Committee Structures

The effectiveness of the board depends significantly on the abilities of the chairman. This is often a lonely and demanding position to which he comes with little training or experience. There has been a scarcity of training for the position of chairman. The chances of success are considerably increased by the ability to access training/development programmes and exchange ideas and approaches out of their own environment with other chairmen.

In order to achieve the objectives of the board, it is up to individual boards to assess their agendas, frequency of debate and an appropriate emphasis on Internal Financial Control/Risk Review. It is important that corporate governance statements reflect substance over form and that practical reviews carried out by the board are referred to in some detail in the Report and Accounts. At present some companies have boilerplate comments when the actual facts could disclose a different picture.

Boards should be as small as practicable, between 6-10 people, to enable proper debate and independence, experience and appropriate executive representation. It is important the executive directors are selected for relevance and ability and are properly prepared by both internal and external programmes.

Board committees should be seen to have an independence of their own and not fitted in as an afterthought to the beginning or end of a board meeting.

Remuneration Committee should be chaired by the senior NED and comprise all NEDs.

Nomination Committee should be chaired by the chairman and should comprise all NEDs (except in the case of appointing a new chairman).

Audit Committee should be chaired by an appropriate financial/accounting skilled NED and comprise all NEDs. If there is no specialist NED then an outside specialist should be co-opted to the Audit Committee to provide up to date technical opinions.

Other committees should be considered, e.g. Health & Safety, Chairman's Committee.

18. Audit Committees

The audit committee is critical to the governance and also the confidence of the shareholders. The composition should include an experienced NED with a financial/accounting background and he should be up to date in these areas. All NEDs should serve on this committee, and executive directors will attend as required – in practice, the financial director, internal auditor and company secretary will be in attendance for significant periods.

The audit committee chairman will meet separately with the audit partner both at the meeting and on other occasions outside of the meeting. He will visit the accounting operations of the company at least twice a year.

The committee will be responsible for recommending the appointment or reappointment of the auditors. The audit partner and audit manager should be changed at least every five years.

The agenda will include the risk review programme in addition to review of accounting statements and internal control.

There is a need to strengthen the Combined Code in respect of the audit committee. Audit committee to be additionally responsible for:

- Recommending the appointment or reappointment of the auditors
- Review of the risk management process carried out by the company
- Approval of any non-audit work to be carried out by the auditors to prevent conflict
- Full report to be included within the Report and Accounts

19. Nomination and Remuneration Committees

A nomination committee is essential to review the ongoing performance of directors, but it is especially critical in terms of appointing a new chairman or chief executive. It is important that executive directors are aware of the process and decision making arrangements. The composition was dealt with above.

The committee should be responsible for, after appropriate consultation with other directors, finalising candidate specification for all board appointments, and agreeing the process for short listing candidates, and appropriate third party assistance. They will recommend the final candidate to the board and confirmation will be for the board as a whole. The nomination committee will ensure that all non-executive appointees undergo appropriate induction. In practice, there is still some way to go to create effective nomination committees.

The remuneration committee has the responsibility to decide the appropriate level of remuneration packages to recruit, motivate and retain executives.

Professional advice should be taken to enable market comparisons to be made and advisors should report to the committee. Board remuneration report should be put to the AGM in the case of significant remuneration policy changes. There is a strong case for linking severance pay compensation to share price as proposed in the Myners Report.

The Annual Report should include a signed report from the chairman of committees reflecting the matters considered during the year.

20. Review Processes

The increasing complexity of boards makes it essential that they review their own performance at least once a year. It should cover content of board agendas, quality of debate, decision taking and style of meeting. The debate should be open and led by the chairman and senior NED alternately. Similarly, the board performance of individual directors should be reviewed by the chairman, after appropriate discussion with the chief executive and senior NED. The board should discuss the performance of the top 20/30 executives in the company on the information provided by the chief executive and be aware of the development/training programmes planned within the company.

21. Reporting Board Performance

As detailed above, more can be done to review board performance. The directors should outline the processes for review of board performance in the Annual Report.

22. NED Challenge

A great deal will depend on chairmanship and the strength of the NEDs, and the quality of courage for NEDs is important. An NED's minority view should be properly reflected in the company's minutes. If there are major or fundamental differences, then it is the responsibility of NEDs to reflect these in the appropriate committee reports. If an NED resigns on a point of difference then it is appropriate for the company to announce the reason.

D. Relationships with Shareholders and Others

23. Relationship with Shareholders

The regular channel of communication with shareholders is through the chief executive and finance director - and the chairman, in special circumstances, should be involved. The chairman should know personally the major shareholders. The company should list in the annual report the major shareholders who own fifty percent of the company. The annual report should also disclose the number of discussions that have taken place with major shareholders during the period.

If the company is performing badly, Institutions can ask to talk to a senior NED but this should be agreed with the chairman and not seen as divisive. It may be appropriate for an NED to attend results meetings or analysts visits, partly for him to understand the views and expectations of shareholders.

24. Chairman and Non Executive Directors

Chairmen should seek to have the views of NEDs at board meetings and provide the appropriate opportunities. Strategic issues, capital investment and acquisitions are particular areas which must carry the confidence and support of the NEDs. Many other matters such a control, people, risk and remuneration will naturally flow through the committees and chairmen must regard these views as fundamental to the board's decisions.

There should be good information flow to enable NEDs to be involved in board decisions. All board meetings should receive a written report from the chief executive and feel that there is an independence of view from executive directors, in particular the finance director.

25. Relationship with Directors

The NEDs should seek an open relationship with executives and senior managers. This will involve meeting them outside the board meetings and also taking the temperature on confidence, culture and morale. If issues arise which give cause for concern, they should first be raised by the NED with the chief executive or chairman before taking them to the board if necessary. Subsidiary board directors would normally meet NEDs at boards held at their location or on presenting their plans to the main board.

Again, the relationship with the chairman and chief executive should be open. At least once a quarter NEDs should meet with the chairman outside the board meeting.

26. Company secretaries in many areas are a bridge between the board and the NEDs. They are regarded as guardians of the system processes of corporate governance as agreed by the board. NEDs should view their support and guidance as very appropriate in these matters.

E. Support

27. Information

Information flows are normally acceptable but it is important that boards agree the information which is required to support decisions. Never accept less than necessary on grounds of time. The NEDs should be aware of information available to management. It is important that NEDs can meet with executives before a board meeting to enable them to have the necessary information and background to reach a personal decision.

28. Training

There are good training and development programmes but they are not reaching a significant number of NEDs. They require funding support either from government or the financial sector and it should be necessary for NEDs to show they have received the appropriate ongoing training which should be reflected in the Directors Report. Consideration should be given to tax incentives to encourage the training of NEDs.

29. Induction

Any new NED should agree an induction programme with the chairman. He should visit all major operations and meet the senior executives. In particular, he should spend time with the chief executive and finance director. He should feel that within three months of joining the company he has secured a good background knowledge to provide an appropriate contribution at board meetings.

30. Guidance

NEDs should have agreed with the chairman what is particularly expected from them both in experience and technical matters. This should be confirmed in the letter of appointment. As with all directors, they should meet annually to have their performance and contributions reviewed by the chairman – issues arising should be confirmed in writing.

F. Smaller Limited Companies

31. Smaller Companies

The responses in principle remain the same for smaller companies. The detail of implementation and compliance may be different in scale and communication and relationship lines shorter.

G. International Context

32. Unitary Boards

The unitary board presents a greater challenge but is by far the most effective board structure.

33. Other Models

Experience does not show that other models are more effective – in fact, the contrary view is held.

34. UK Practice

It would not be beneficial unless there are issues of Global Compliance.