

## **Review of the role and effectiveness of non-executive directors**

### **Response by UK Society of Investment Professionals**

#### **About UKSIP**

The UK Society of Investment Professionals (UKSIP) has over 4,000 investment professionals as its members. The majority of these members also belong to the Association for Investment Management and Research (AIMR) the global standards body of which UKSIP is the UK-based Society. Both AIMR and UKSIP provide support for the Chartered Financial Analyst (CFA) designation and over 100,000 candidates sat parts of the CFA exams in 2001. Currently there are 1,321 CFA Charterholders in the UK and, during 2002, over 5,000 candidates sat the three levels of the CFA examination here.

With professional excellence at the core of its objectives, UKSIP itself runs the Investment Management Certificate, the entry level qualification of choice for those wishing to become investment analysts or fund managers in the UK and for those seeking an introduction to investment management. Success at UKSIP's Associate Examination enables investment professionals to use the ASIP designation, offering recognition of high achievement.

#### **Consultation Paper 7 June 2002 – UKSIP Responses**

##### **A: Role**

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

Q1 *What is the role of the board? What is the role of the Chairman and how does it relate to the non-executive directors?*

The board's role is to lead and control the company, and all of its directors face the challenge of creating long term shareholder value. It is the Chairman's responsibility to ensure that the board works as effectively as possible and that all directors – executive and non-executive – are able to contribute fully. In particular, the Chairman should encourage non-executives to actively participate in strategic planning and to challenge and constructively criticise its development and execution. The Chairman may have a particular role in ensuring that the company's chief executive and his team of executive directors fully recognise the valuable input that experienced and well qualified non-executives can offer. This is crucial and failure by the Chairman to act decisively on issues such as this will defeat the object of splitting the roles of Chairman and Chief Executive.

Q2 *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?*

Non-executives have two clearly defined roles in supporting their executive colleagues to develop long-term shareholder value. The first is to have a constructive input into strategy and the second is to help ensure that its implementation takes place within agreed risk parameters. One manifestation of this is the role of non-executives on audit and other board committees, where they should have a lead responsibility. In a company with well-developed systems and controls, most of the non-executives' effort should be concentrated on supporting business development; in others, non-executives may have a more time consuming role to fulfil in relation to the monitoring of risk. Ideally, a split of 80/20-strategy/risk controls – would be likely to make the most use of a non-executive's contribution.

There is now a high expectation that non-executives will work to ensure that compensation arrangements for executive directors are fair. Non-executives can also offer much towards improving a company's corporate social responsibility profile by giving independent feedback to the board on such matters. They can also keep an eye on issues such as the effectiveness of information provided to shareholders.

It is important that all non-executives are committed to board strategy and to ensuring that the board is accountable for its actions; it may be unrealistic to expect individual non-executives to fulfil the potential full range of roles. It is clearly important that non-executives with, say, audit committee responsibilities have financial acumen.

Q3 *How does this compare with the present position?*

It is unusual for non-executive directors to meet with shareholders at present, other than in formalised situations such as at the Annual General Meeting. This means that non-executives must rely on third party intelligence regarding the key board/shareholder relationship. It is evident, however, that – in reality – there is minimal shareholder involvement, in the selection, appointment or performance monitoring of non-executives. A closer and more active relationship between leading shareholders and members of the company's nomination committee could help.

Non-executives with executive responsibilities elsewhere are also likely to find it difficult to fulfil part time responsibilities on more than one or two boards. Some “professional” non-executives also appear to have too a large number of such director responsibilities; clearly, a point will be reached when it is not possible to give adequate time to the needs of particular boards, especially if the company concerned requires extra attention. Inevitably, however, it is difficult to generalise.

Q4 *How independent do non-executive directors need to be for the different roles?*

At various times, non-executive members of a company's board, in particular, will need to demonstrate independence of mind. Challenges to executive proposals may need to be forthright, as well as soundly researched and timely. Questions of potential personal gain by particular non-executives will need to be put to one side, if those involved are to fully represent the interests of investors. At a time when a company is facing difficulties, it is also likely that non-executives will need to be able to demonstrate their independence to shareholders, analysts and others. This is a real test of a board's non-executives and "baling out" at such times can demonstrate a lack of commitment on a non-executive's part. Nonetheless, if one or more non-executives feel frustrated by actions of executive colleagues, the ultimate power of resignation should not be underestimated. However, in allowing such a situation to develop, the Chairman may well attract justified criticism.

The concept of "whistle blowing" has been promoted as a "last resort" option in relation to pensions provision, for instance. If necessary, non-executives could contact regulators, should they be sufficiently concerned about relevant issues or, in appropriate circumstances, the company's auditors. Clearly this is a difficult proposition to make and, in that situation, a non-executive "whistle blower" would probably need to be offered some financial cushion.

Q5 *What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a role in protecting the interests of the company? What can be done to help non-executive directors to be effective in relation to these conflicts?*

The main potential conflicts of interest which may arise – or which others may feel will arise – relate either to the personal gain of individual non-executive directors or to the situation where one or more individuals or other third party – related to the non-executive director in question – could benefit.

Whilst the Hampel Committee failed to offer a detailed definition of non-executive director independence, the National Association of Pension Funds (NAPF) developed a definition with support from the Association of British Insurers. The definition in question – though only a rough, prima facie guide to independence – has helped both investors and boards to focus on the main potential conflicts of interest.

Q6 *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?*

These are important questions for, if a non-executive director finds that one or more of his board responsibilities becomes more demanding, he must have the capacity available to make the additional contribution needed. A Chairman or non-executive – with executive responsibilities elsewhere – should clearly take on fewer non-executive positions than an individual without those full

time duties. Without wishing to be too prescriptive, conventional wisdom suggests that an executive director could benefit from one or two non-executive roles, whilst a full time non-executive could manage up to, say, five “normal” board posts. Were an individual to join a board with significant problems, that number would probably need to be adjusted downwards.

Q7 *Should there be a special role for a “senior independent” non-executive director?*

Provided a board contains non-executive directors of an appropriate calibre and level of independence, such a role would seem to be unnecessary. However, a number of major shareholders have called for a senior independent director, suggesting that, for some boards at least, such a role could be justified. Again, if institutions press for such an individual to be identified, is discontent with the Chairmanship of the board being indicated?

Q8 *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?*

Without commenting on the detail of the proposed statutory statement, the fact that it does not seek to distinguish between executive and non-executive directors would be consistent with the general wish that non-executives on the board should be as fully involved as possible.

**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?**

Q9 *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?*

Non-executive directors must have the key skills necessary to contribute to strategic planning, to understand the financial fundamentals of the business, and to participate fully in board evaluation and decisions on major issues of business direction. They should also have an ability to understand the risks inherent in the business in question. Hence, those with prior experience in leadership positions – preferably from the same or a related industry – will be at a premium. There may also be a case for seeking representatives from amongst major investors.

Q10 *What personal qualities and attributes are needed?*

In terms of personal qualities they will need to show intellect, tact and strength of character on occasion, as well as a basic knowledge of the industry concerned.

- Q11 *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.*

The Chairman with responsibility for the effectiveness of the board, should be responsible for ensuring that the experience and mix of its members is appropriate. Non-executives with a good understanding of shareholder sentiment have helped companies to avoid the worst excesses of directors' pay; audit committee members with financial knowledge are likely to have challenged a number of accounting and audit issues. Specific examples are likely to be available from business schools such as Henley and Cranfield and from the NED Forum, all of which offer training which draw on case studies. Major institutional investors will also have examples available.

- Q12 *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?*

Companies have suggested that it is becoming more difficult to recruit non-executive directors with the right skills and attributes. This is understandable because of the increasing expectations of non-executives. There are, at least, two further factors namely the pressure on non-executives to reduce the number of such appointments and the wish of boards to secure non-executives with main board executive responsibilities elsewhere.

- Q13 *What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?*

The constraints on widening the pool of potential non-executive directors has effectively been discussed in the context of essential skills, and so forth. However, it is evident that the pool must be widened and greater international representation on UK boards would be consistent with globalisation trends. As many boards rely on recruitment consultants for advice, they should have a role in encouraging boards to look farther afield.

- Q14 *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?*

Rewards for non-executive directors do not appear to have kept pace with pay inflation in general, let alone the pay of their executive colleagues. Ironically, directors' fees should not be the determining factor of whether an individual feels able to accept a non-executive post; nonetheless, with issues such as loss of reputation very much in a potential non-executive's mind, levels of reward should be commensurate with the increase in responsibilities placed on a non-executive. This suggests that current levels of non-executive director fees are too low.

Q15 *Do you have comments on the issue of risks or insurance provision for non-executive directors?*

Non-executives should be covered by insurance.

**C: Structures and accountability**

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

Q16 *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?*

Company directors and secretaries will be best placed to indicate whether and to what extent, if any, the Combined Code has inhibited board effectiveness. From the investor's viewpoint, the Code has provided some measure of assurance that, in terms of structures at least, boards are complying with perceived good practice. Boards are understood to be familiar with the definition of independence drawn up by the NAPF, a further definition may not be required.

Q17 *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?*

The size and structure of board committees are probably not the determining factors in relation to effectiveness. Similarly, board size is likely to be less crucial than the effectiveness of its individual members. Clearly both board committees and the board itself must be of a sufficient size to benefit from the sharing of input and workload.

Executive directors may too often determine agendas for meetings of some boards. The Chairman should set the agenda and should ensure that the Board is given sufficient opportunity and information to prepare for effective discussion of the issues. The role of the Company Secretary is vital in this respect.

Non-executives should not be discouraged from speaking out, especially where they harbour reservations concerning strategy or risk management.

Q18 *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?*

Recent US experience has confirmed the view of many investors that the role of non-executives on the Audit Committee is crucial and that its expertise may well need further strengthening. It is therefore important that Audit

Committee members have financial acumen and are robust in challenging both risk control structures and the presentation of data. Although the extent to which this can be achieved, in practice, must remain questionable, the Audit Committee should be made aware and have oversight of any non-audit services provided by the company's auditor.

Whilst the expectation of what Audit Committee members can achieve may be limited, it is worth remembering that a company's annual accounts are produced every year in on a pre-determined timetable and in accordance with accounting conventions and standards which are becoming international. Hence it should be feasible for Audit Committee members to have access to the necessary expertise and information to be satisfied as to the accuracy and relevance of the accounts. As accountancy principles and practice have been mastered by many, a committee with financial acumen and access to advice should be able to identify the tell tale signs of questionable accounting practice often evident to the informed reviewer.

Q19 *Do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?*

It is clearly appropriate that potential board appointees are subject to screening by the Nomination Committee and to formal board approval. In the case of major enterprises, remuneration committees will continue to be in the spotlight whilst executive remuneration runs ahead of shareholder expectation.

Q20 *What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?*

Board evaluation, preferably by an outside third party, is likely to have a positive impact on board performance. Understandably, few companies report publicly on their use of board evaluation. As part of a planned evaluation programme, the setting of objectives for board members is suggested. When setting objectives for executive directors, the intention is that they should be encouraged to promote board effectiveness so that the enterprise can benefit from input provided by well informed non-executives.

Q21 *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?*

Such outcome can be achieved from effective board evaluation. Board evaluation is clearly not the norm at present and public reporting of its findings even less so.

Q22 *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?*

Evidence from amongst companies should provide key data to this question. Ultimately, if concerned about such matters, non-executives have the option of resigning on a matter of principle. Such a course of action is clearly easier if the non-executive concerned enjoys financial independence from the company.

**D: Relationships with shareholders and others**

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

Q23 *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?*

It is not normal for institutional shareholders to meet with non-executive directors of a particular company. One of the reasons may be a lack of time available to the non-executive or a view by their executive colleagues that direct meetings could undermine normal shareholder relationships. Entrenched views on this matter are likely to take some time to change, notwithstanding the Myners' recommendation proposing regular such meetings.

Q24 *To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more than 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?*

Good practice guides on such matters are likely to be available to Chairmen from organisations such as the Institute of Directors (IoD). The IoD, for instance, publishes "Chairing the Board". Chairmen could achieve much by ensuring that board papers are prepared on a timely basis and contain information of greatest relevance to board members. A refusal by the Chairmen to discuss business minutiae at board meetings could achieve much in some cases.

Goals set by the Remuneration Committee for the Chief Executive could include the nature of that individual's relationship with non-executive board members. The non-executives could also be set performance goals to be reviewed by the Chairman. It is, of course, unlikely that they will have been set objective performance criteria on appointment.

Q25 *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 Chief Executive? What should their relationship be with key advisers to the Company?*

In every respect relationships should be confident and constructive. Without this the purpose of the Unitary Board is defeated and the role of effective non-executive directors much more difficult to fulfil.

Q26 *How can Company Secretaries support effective performance by non-executive directors?*

The importance of the role of an effective Company Secretary is difficult to overstate. The Secretary should be the officer of the company with the technical expertise to advise the board on effective governance procedures and, for instance, on the advisability of board evaluation exercises.

#### **E: Support**

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

Q27 *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?*

The expectation of investors is that non-executive directors will have free access to all the information they request. Time constraints – often self-imposed – may be significant inhibitors to the growth in non-executive director knowledge of the enterprise in question.

Q28-

Q30 No comment

#### **F: Smaller listed companies**

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

Q31 To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?

Whilst it is likely that organisations such as the Quoted Companies Alliance will provide detailed comment, the principles underlying governance and the Combined Code should apply equally to enterprises of all sizes. Investors understand, however, that the number and experience of non-executive directors in smaller enterprises will vary from that in larger companies.

#### **G: International context**

##### **What can we learn from international experience?**

Q32 *What lessons can be learnt from international experience, either in terms of structures or behaviours?*

Q33 *Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?*

Q34 *Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?*

One of the lessons to be learnt from international experience is that investor expectations, worldwide, are broadly similar in nature. Organisations such as the International Corporate Governance Network have introduced global principles to which investors expect major companies to adhere. These are not – and should not be – detailed rules. Different models of corporate governance should exist in different markets and thereby reflect the circumstances of the market in question. It would be wrong to impose UK standards in an alien market environment and vice versa. Nonetheless, “quality of management” issues should be universal, as should the standards of personal ethics and probity. The drive towards internationally agreed accounting standards is a significant factor and should bring widely divergent market practices more broadly into line.

Please note that, in view of the public interest in these matters, UKSIP will be briefing the press on the basis of this response.

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