3 THE ROLE OF DIRECTORS

3.1 In this chapter we deal with the responsibilities of directors, the structure and composition of the board, and the appointment of suitable individuals to it. We deal with directors’ remuneration in the following chapter.

A Duties

3.2 The basic legal duties of directors are to act in good faith in the interests of the company and for a proper purpose; and to exercise care and skill. These are derived from common law and are common to all directors. The duties are owed to the company, meaning generally the shareholders collectively, both present and future, not the shareholders at a given point in time.

3.3 There is a view that non-executive directors should face less onerous duties than executive directors, since they will inevitably be less well informed about the company’s business. However, we support the retention of common duties in the interests of the unity and cohesion of the board. Where the English courts are called upon to decide whether a director has fulfilled his or her duty, they have recently tended to take into account such factors as the position of the director concerned (e.g. whether he or she is a full time executive director or a non-executive director) and the type of company. We consider this to be a helpful recognition of the practical situation.

B Supply of Information

3.4 The effectiveness of a board (including in particular the role played by the non-executive directors) is dependent to a substantial extent on the form, timing and quality of the information which it receives. Reliance purely on what is volunteered by management is unlikely to be enough in all circumstances and further enquiries may be necessary if the particular director is to fulfil his or her
duties properly. Management has an obligation to ensure an appropriate supply of information. In addition, we endorse Cadbury’s view (report, 4.8) that the chairman has a particular responsibility to ensure that all directors are properly briefed on issues arising at board meetings.

C Training

3.5 We agree with Cadbury that, on the first occasion that an individual is appointed to the board of a listed company, he or she should receive induction into the responsibilities of a director. It is the board’s responsibility to ensure that this help is available. It is equally important that directors should receive further training from time to time, particularly on relevant new laws and regulations and changing commercial risks.

D Executive Directors

3.6 Executive directors share with their non-executive colleagues overall responsibility for the leadership and control of the company. As well as speaking for the business area or function for which he or she is directly responsible, an executive director should exercise individual judgement on every issue coming before the board, in the overall interests of the company. In particular, an executive director other than the chief executive officer needs to be able to express views to the board which are different from those of the chief executive officer and be confident that, provided that this is done in a considered way, the individual will not suffer. Boards should only appoint as directors executives whom they judge to be able to contribute in these ways. Board appointment should not be regarded simply as a reward for good performance in an executive role.
E Non-executive Directors

3.7 The Cadbury committee raised the profile of the non-executive director, and this has been very beneficial. An unintended side effect has been to overemphasise the monitoring role. The Cadbury committee themselves recognised the danger:

'The emphasis in this report on the control function of non-executive directors is a consequence of our remit and should not in any way detract from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company'. (Report, 4.10.)

3.8 Non-executive directors are normally appointed to the board primarily for their contribution to the development of the company's strategy. This is clearly right. We have found general acceptance that non-executive directors should have both a strategic and a monitoring function. In addition, and particularly in smaller companies, non-executive directors may contribute valuable expertise not otherwise available to management; or they may act as mentors to relatively inexperienced executives. What matters in every case is that the non-executive directors should command the respect of the executives and should be able to work with them in a cohesive team to further the company's interests.

3.9 The Cadbury committee recommended that a majority of non-executive directors should be independent, and defined this as 'independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement' (report, 4.12). We agree with this definition, and after careful consideration we do not consider that it is practicable to lay down more precise criteria for independence. We agree with Cadbury that it should be for the board to take a view on whether an
individual director is independent in the above sense. The corollary is that boards should disclose in the annual report which of the directors are considered to be independent and be prepared to justify their view if challenged. We recognise, however, that non-executive directors who are not in this sense 'independent' may nonetheless make a useful contribution to the board.

3.10 Some smaller companies have claimed that they cannot find a sufficient number of independent non-executive directors of suitable calibre. This is a real difficulty, but the need for a robust independent voice on the board is as strong in smaller companies as in large ones. In many smaller companies the executives are also major shareholders; and the level of external scrutiny by other shareholders and the market is low. Non-executive directors do a vital job in safeguarding minority interests and ensuring good governance. We have already noted (1.10) the need to consider the governance arrangements of smaller companies with flexibility and proper regard to individual circumstances.

II The Board

3.11 The prime responsibility of the board of directors is to determine the broad strategy of the company and to ensure its implementation. To do this successfully requires high quality leadership. It also requires that the directors have sufficient freedom of action to exercise their leadership. The board can only fulfill its responsibilities if it meets regularly and reasonably often.

A Structure

3.12 We have found overwhelming support for the unitary board of the type common in the UK. There was little enthusiasm for a two-tier framework. The unitary board offers considerable flexibility. The board may delegate functions to board committees. Audit, remuneration and nomination committees play an important role in
Role of Directors

corporate governance. Some boards delegate operational decisions to an executive committee, and so adopt some of the features of the two tier board. In our view this is entirely a matter for the individual company.

B Performance

3.13 A recent report of the US National Association of Corporate Directors recommended the introduction of formal procedures by which boards would assess both their own collective performance and that of individual directors. Some UK boards already operate such procedures. We believe that this is an interesting development which boards might usefully consider in the interest of continuous improvement, though we do not feel able at this stage to make a firm recommendation on the subject.

III Board Composition

A Balance

3.14 Large companies often have roughly equal numbers of executive and non-executive directors; smaller listed companies tend to have a majority of executive directors. Non-executive directors have an important part to play in corporate governance. We believe that it is difficult for them to be effective if they make up less than one third of the board.

B Diversity

3.15 Most non-executive directors are executives or former executives of other companies. This experience qualifies them both in constructive policy making and in the monitoring role. Non-executive directors from other backgrounds are often appointed for their technical knowledge, their knowledge of overseas markets or their political contacts. It was put to us that companies should recruit directors from a greater diversity of backgrounds. We do not favour diversity for its own sake, to
givc a politically correct appearance to the list of board members or to represent stakeholders. But we believe, given the diversity of business and size of listed companies, that there are people from other fields who can make a real contribution on the board.

IV The Chairman and the Chief Executive Officer

3.16 The chairman’s job was described by Cadbury in the following terms:

‘Chairmen are primarily responsible for the working of the board, for the balance of its membership subject to board and shareholders’ approval, and for ensuring that all directors, executive and non-executive alike, are enabled to play their full part in its activities’ (report, 4.7).

The chief executive officer’s task is to run the business and to implement the policies and strategies adopted by the board. There are thus two distinct roles. Subject to our view on the role of the nomination committee in board appointments (3.19 below), we endorse this description.

3.17 Cadbury recommended that the roles of chairman and chief executive officer should in principle be separate; if they were combined in one person, that represented a considerable concentration of power. We agree with Cadbury’s recommendation and reasoning, and we also note that in the largest companies there may be two full-time jobs. But a number of companies have combined the two roles successfully, either permanently or for a time. Our view is that, other things being equal, the roles of chairman and chief executive officer are better kept separate, in reality as well as in name. Where the roles are combined, the onus should be on the board to explain and justify the fact.
3.18 **Cadbury** also recommended that where the roles of chairman and chief executive officer were combined there should be a strong and independent element on the board, with a recognised senior member (code 1.2). But even where the roles of chairman and chief executive officer are separated, we see a need for vigorously independent non-executive directors. There can, in particular, be occasions when there is a need to convey concerns to the board other than through the chairman or chief executive officer. To cover this eventuality we recommend that a senior independent non-executive director — e.g. a deputy chairman or the chairman of the remuneration committee — should have been identified in the annual report. We do not envisage that this individual would for this purpose need special responsibilities or an independent leadership role, nor do we think that to identify him or her should be divisive.

V Board Membership

A Appointment

3.19 Appointment to the board should be a transparent process. Decisions should be taken in reality as well as in form, by the whole board. We support the Cadbury committee’s endorsement of the nomination committee (report 4.30); indeed, we believe that the use of such a committee should be accepted as best practice with the proviso that smaller boards may prefer to fulfil the function themselves.

3.20 In general, we see the appointment of directors to represent outside interests as incompatible with board cohesion, but there may be exceptional cases where it is appropriate for a major creditor or a major shareholder to nominate a director. Shareholders are, of course, free to submit names for consideration by the nomination committee. Where there is a close relationship between a company and its major shareholders, such suggestions may be appropriate. This is a matter for the shareholders and the company.
B Re-election

3.21 Directors of listed companies are required by the Listing Rules to submit themselves for election at the first AGM after their appointment. The National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI) expect all directors to submit themselves for re-election at intervals of no more than three years. We strongly agree and have already proposed as a principle of good corporate governance that all directors should be required to submit themselves for re-election at regular intervals of no more than three years. We recommend that those companies who do not as yet conform with this principle should make the necessary changes in their Articles of Association as soon as possible. We also recommend that all names submitted for election or re-election as directors should be accompanied by biographical details indicating their relevant qualifications and experience. This will enable shareholders to take an informed decision whether to support the director’s re-election.

3.22 Some have proposed that companies should not disapply the statutory age limit for directors of 70; or alternatively that directors over the age of 70 should submit themselves for re-election annually. Others have suggested a maximum period of ten years’ service for non-executive directors. This assumes that the effectiveness and objectivity of the director will decline with increasing age and length of service. There is a risk that this could happen, and boards, and the individuals themselves, should be vigilant against it. But a reasonably long period on the board can give directors a deeper understanding of the company’s business and enable them to make a more effective contribution. Individuals’ capacities, and their enthusiasm for the task, vary widely, and a recommendation would be inappropriate.
C Resignation

3.23 There is a view that once a director has been elected to serve, he owes it to the shareholders to complete his term, or to give an explanation if he is unable to do so. There are many reasons for a director’s resignation which need not concern shareholders — health, family commitments, increased work commitments elsewhere; in these cases the privacy of the individual should be respected. But it has been suggested to us that shareholders are entitled to know if a resignation results from a policy disagreement or a personality clash. This may be helpful in appropriate cases; there are likely to be rumours, and open disclosure may be in shareholders’ interests.