

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

January 2003



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

**Derek Higgs  
January 2003**

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## Letter from Derek Higgs to the Chancellor of the Exchequer and the Secretary of State for Trade and Industry

*Dear Chancellor and Secretary of State*

Walter Bagehot famously wrote of the monarchy in 1867: "We must not let in daylight upon magic". In the corporate boardroom, the importance of the non-executive director is recognised but their role, perhaps like that of the monarchy of old, is largely invisible and poorly understood. When corporate strategies fail or governance lapses, however, attention rightly focuses on the contribution of the non-executive director.

Against a background of corporate turbulence, it is very much the purpose of this Review to let in some daylight on the role of the non-executive director in the boardroom and to make recommendations to enhance their effectiveness.

From the work I have done, I am clear that the fundamentals of corporate governance in the UK are sound, thanks to Sir Adrian Cadbury and those who built on his foundations. The Combined Code and its philosophy of "comply or explain" is being increasingly emulated outside the UK. It offers flexibility and intelligent discretion and allows for the valid exception to the sound rule. The brittleness and rigidity of legislation cannot dictate the behaviour, or foster the trust, I believe is fundamental to the effective unitary board and to superior corporate performance.

But the Code can and should regularly evolve to lead best practice in the boardroom and raise the bar for performance. Since the Code was adopted in its present form, the most progressive companies have continued to improve the rigour and effectiveness of the work of their boards. As a result many listed companies exceed its current provisions, and there is every reason why all companies should aspire to the standards of the best.

My Review has therefore aimed principally to advance and reflect best practice through proposed revisions to the Code. It includes focus on the behaviours and relationships, and the need for the best people, which are essential for an effective board.

I hope that my recommendations will be adopted in early revisions to the Code. I hope, too, that a reader of the Review and its associated research will feel that some daylight has indeed been let in on the workings of the board, magical or otherwise.

If I have achieved this, it is in very large part due to the many individuals and organisations who have contributed time, experience and thoughtfulness to the process. In particular, I am indebted to Anne Willcocks of the Department of Trade and Industry and Andrew Paulson of HM Treasury, and their colleagues, for their energy, enthusiasm and dedication and not least for their patience with me.

*Yours sincerely*

*Derek Higgs*

Derek Higgs  
20 January 2003



# SUMMARY OF RECOMMENDATIONS

## The board

- The board is collectively responsible for promoting the success of the company by leading and directing the company's affairs. A description of the role of the board is proposed for incorporation into the Combined Code (the Code) (Box opening Chapter 4).
- The number of meetings of the board and of its main committees should be stated in the annual report, together with the attendance of individual directors (paragraph 4.8). A description should be included in the annual report of how the board operates (paragraph 4.8).
- The board should be of an appropriate size (paragraph 4.10). At least half the members of the board, excluding the chairman, should be independent non-executive directors (paragraph 9.5). There should also be a strong executive representation on the board (paragraph 8.6).

## The chairman

- The chairman has a pivotal role in creating the conditions for individual director and board effectiveness. The Review describes the role of the chairman (Chapter 5) and some of the attributes and behaviours of an effective chairman (Annex D).
- The roles of chairman and chief executive should be separated (paragraph 5.3) and the division of responsibilities between the chairman and chief executive set out in writing and agreed by the board (paragraph 5.5).
- A chief executive should not become chairman of the same company (paragraph 5.7). At the time of appointment the chairman should meet the test of independence set out in the Review (paragraph 5.8).

## Role of the non-executive director

- A description of the role of the non-executive director is proposed for incorporation into the Code (Box opening Chapter 6). Guidance is offered for non-executive directors on how to maximise their effectiveness (Annex C).
- The non-executive directors should meet as a group at least once a year without the chairman or executive directors present and the annual report should include a statement on whether such meetings have occurred (paragraph 8.8).

- Prior to appointment, potential new non-executive directors should carry out due diligence on the board and on the company to satisfy themselves that they have the knowledge, skills, experience and time to make a positive contribution to the board. Guidance on pre-appointment due diligence is offered (Annex G).

## The senior independent director

- A senior independent director should be identified who meets the test of independence set out in the Review. The senior independent director should be available to shareholders, if they have concerns that have not been resolved through the normal channels of contact with the chairman or chief executive (paragraphs 7.4 to 7.5).

## Independence

- All directors should take decisions objectively in the interests of the company (paragraph 9.10).
- A definition of independence is proposed for incorporation into the Code (paragraph 9.11).

## Recruitment and appointment

- There should be a nomination committee of the board to conduct the process for board appointments and make recommendations to the board (paragraph 10.9).
- The nomination committee should consist of a majority of independent non-executive directors. It may include the chairman of the board, but should be chaired by an independent non-executive director. A statement should be made in the annual report setting out the composition, terms of reference, and activities of the nomination committee and the process used for appointments (paragraph 10.9). A summary of the principal duties of the nomination committee is offered (Annex F).
- The nomination committee should evaluate the balance of skills, knowledge and experience on the board and prepare a description of the role and capabilities required for a particular appointment (paragraph 10.9).
- On appointment, non-executive directors should receive a letter setting out what is expected of them (paragraph 10.9). A specimen letter of appointment is offered (Annex H).
- The nomination committee should provide support to the board on succession planning (paragraph 10.13).
- Chairmen and chief executives should consider implementing executive development programmes to train and develop suitable individuals in their companies for future director roles (paragraph 10.14).

- The board should set out to shareholders why they believe an individual should be appointed to a non-executive director role and how they meet the requirements of the role (paragraph 10.11).
- Proposals are made to broaden the pool of candidates for non-executive director appointments, including more executive directors and senior executives from other companies and directors of private companies, as well as advisors and those from other backgrounds (paragraphs 10.25 to 10.31).
- A small group of business leaders and others will be set up to identify how to bring to greater prominence candidates for non-executive director appointment from the non-commercial sector (paragraph 10.32).
- The Review offers guidance on the process for the appointment of a new chairman (paragraph 10.35).

## Induction and professional development

- A comprehensive induction programme should be provided to new non-executive directors (paragraph 11.1) and is the responsibility of the chairman, supported by the company secretary (paragraph 11.4). The Review provides an induction checklist (Annex I).
- The chairman should address the developmental needs of the board as a whole with a view to enhancing its effectiveness. Resources should be provided for developing and refreshing the knowledge and skills of directors (paragraph 11.14).
- The performance of the board, its committees and its individual members, should be evaluated at least once a year. The annual report should state whether such performance reviews are taking place and how they are conducted (paragraph 11.22).
- Supported by the company secretary, the chairman should assess what information is required by the board (paragraph 11.26). Non-executive directors should satisfy themselves that they have appropriate information of sufficient quality to make sound judgements (paragraph 11.27).
- The company secretary should be accountable to the board as a whole, through the chairman, on all governance matters (paragraph 11.31).

## Tenure and time commitment

- A non-executive director should normally be expected to serve two three-year terms, although a longer term will exceptionally be appropriate (paragraph 12.5).

- On appointment, non-executive directors should undertake that they will have sufficient time to meet what is expected of them, taking into account their other commitments (paragraph 12.13). If a non-executive director is offered appointments elsewhere, the chairman should be informed before any new appointment is accepted (paragraph 12.14).
- The nomination committee should annually review the time required of non-executive directors. The performance evaluation should assess whether non-executive directors are devoting enough time to fulfil their duties (paragraph 12.14).
- A full time executive director should not take on more than one non-executive directorship, nor become chairman, of a major company. No individual should chair the board of more than one major company (paragraph 12.19).

## Remuneration

- The remuneration of a non-executive director should be sufficient to attract and fairly compensate high quality individuals. It may comprise an annual fee, a meeting attendance fee, and an additional fee for the chairmanship of committees (paragraph 12.24). Non-executive directors should have the opportunity to take part of their remuneration in the form of shares (paragraph 12.26).
- Non-executive directors should not hold options over shares in their company. If, exceptionally, some payment is made by means of options, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until one year after the non-executive director leaves the board (paragraph 12.27).
- Where a company releases an executive director to serve as a non-executive director elsewhere, it should include in its remuneration policy report whether or not the director will retain the related remuneration and, if so, its amount (paragraph 12.28).

## Resignation

- Where a non-executive director has concerns about the way in which a company is being run or about a course of action proposed by the board, these should be raised with the chairman and their fellow directors. Non-executive directors should ensure their concerns are recorded in the minutes of the board meetings if they cannot be resolved (paragraph 12.31).
- On resignation, a non-executive director should inform the chairman in writing, for circulation to the board, of the reasons for resignation (paragraph 12.32).

## Audit and remuneration committees

- Sir Robert Smith's recommendations on audit committees, published today, are endorsed (paragraph 13.7).

- The remuneration committee should comprise at least three members, all of whom should be independent non-executive directors. It should have published terms of reference (paragraph 13.11). The Review offers a summary of the principal duties of the remuneration committee (Annex E).
- The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman. The committee should also set the level and structure of compensation for senior executives. The committee should be responsible for appointing remuneration consultants (paragraph 13.12).
- No one non-executive director should sit on all three principal board committees (audit, nomination and remuneration) simultaneously (paragraph 13.2).

## Liability

- Guidance is provided for incorporation into the Code on the position of a non-executive director, which may be relevant to the determination of liability (paragraph 14.8).
- The Review invites the Lord Chancellor's Department to consider steps to promote active case management in cases applying to directors (paragraph 14.11).
- The Government is recommended to consider the principles set out by the Company Law Review in considering criminal sanctions in relation to directors (paragraph 14.12).
- A company should be able to indemnify a director in advance against the reasonable cost of defending proceedings from the company itself, without trying to establish in advance the prospects of success of the case (paragraph 14.16).
- Companies should provide appropriate directors' and officers' insurance and supply details of their insurance cover to potential non-executive directors before they are appointed (paragraph 14.19).
- The City of London Law Society and the Institute of Chartered Secretaries and Administrators (ICSA), together with the Association of British Insurers (ABI) and the British Insurance Brokers' Association (BIBA), have agreed to draw up guidance on insurance for directors for companies to use in obtaining appropriate directors' and officers' insurance (paragraph 14.20).

## Relationships with shareholders

- All non-executive directors, and in particular chairmen of the principal board committees, should attend the Annual General Meeting (AGM) to discuss issues that are raised in relation to their role (paragraph 15.10).

- The senior independent director should attend sufficient of the regular meetings of management with a range of major shareholders to develop a balanced understanding of the themes, issues and concerns of shareholders. The senior independent director should communicate these views to the non-executive directors and, as appropriate, to the board as a whole (paragraph 15.15).
- Boards should recognise that non-executive directors may find it instructive to attend meetings with major investors from time to time and should be able to do so if they choose. Moreover, non-executive directors should expect to attend such meetings if requested by major investors in the company (paragraph 15.16).
- On appointment, meetings should be arranged for non-executive directors with major investors, as part of the induction process (paragraph 15.17).
- A company should state what steps it has taken to ensure that the members of the board, and in particular the non-executive directors, develop a balanced understanding of the views of major investors (paragraph 15.18).
- The Review endorses the Government's approach to more active engagement by institutional shareholders with the companies in which they invest, and the Institutional Shareholder Committee's (ISC) code of activism. Institutional investors should attend AGMs where practicable (paragraph 15.24).

## Smaller listed companies

- The recommendation that no one individual should sit on all three principal board committees at the same time should not apply to smaller listed companies. With this exception, there should be no differentiation in the Code's provisions for larger and smaller companies. It may take more time for smaller listed companies to comply fully with the Code and it is recognised that some of its provisions may be less relevant or manageable for smaller companies (paragraph 16.8).

## Making change happen

- Most of the recommendations are for changes to the Code. These are consolidated in Annex A. It is hoped that the Financial Reporting Council (FRC) and the Financial Services Authority (FSA) will wish to take forward the Review's proposals and that the resulting changes will be introduced as soon as practicably possible, preferably for reporting years starting on or after 1 July 2003.
- To determine the extent to which behaviour has changed as a result of these proposals, it is recommended that the Government and the FRC review progress in two years' time on the proposals made by the Review (paragraph 17.11).

# INTRODUCTION

- 1.1 Effective and robust boards are an essential feature of successful companies. Within the unitary board, non-executive directors have a crucial part to play. Their role and their effectiveness is the subject of this Review.
- 1.2 The Review further develops the UK framework of corporate governance, which commenced in earnest with the publication of the Cadbury report in 1992 and was taken forward by the Greenbury, Hampel and Turnbull reports. It forms part of a systematic re-appraisal, across leading market economies, of the adequacy of corporate governance arrangements in the wake of recent corporate failures. It also takes place against the backdrop of one of the most severe bear markets witnessed in recent times.
- 1.3 Governance shortcomings have contributed to falling markets. The combination of the two has in some cases been the trigger for corporate collapse. Corporate malpractice, lapses of governance and value destruction – all these raise questions about the role and effectiveness of non-executive directors.
- 1.4 They also introduce questions of public policy. With much of UK value creation coming from the listed company sector, effective boards are a key element of UK corporate performance. Ensuring the highest standards of boardroom governance can only assist in closing the productivity gap that exists with our major competitors.
- 1.5 Corporate governance provides an architecture of accountability – the structures and processes to ensure companies are managed in the interests of their owners. But architecture in itself does not deliver good outcomes. The Review therefore also focuses on the conditions and behaviours necessary for non-executive directors to be fully effective.
- 1.6 Non-executive directors are the custodians of the governance process. Expectations of non-executive directors have risen as increased business complexity has made it more difficult for individual shareholders effectively to hold management to account. Rising executive remuneration has also, rightly, made shareholders keen to ensure that performance and reward are kept properly aligned.
- 1.7 Some have argued that the increasing complexity of business life – whether globalisation or fast changing product and capital markets – is such that the whole structure of the board needs to be re-considered. But the majority view, which I share, sees considerable benefits continuing to flow from the unitary approach.
- 1.8 In the current global discussion about corporate governance, the UK is relatively advantaged. Our approach has been evolving for more than a decade and the habits and instincts which breathe life into the system have also matured. Transparency and accountability are more developed than in some other markets.

- 1.9 But there is much more that can be done. Costly boardroom failures, resulting in great loss of value and jobs, provide ready grounds for humility. Moreover, whatever lead the UK may have had in this area has not been used to full advantage. Too often the governance discussion has been shrill and narrowly focused on executive pay with insufficient attention to the real drivers of corporate success. It would represent progress if this Review were to open a richer seam of discussion, one with board performance and effectiveness at the core.
- 1.10 Corporate failure, of course, will always be with us. Enterprise creates prosperity but involves risk. No system of governance can or should fully protect companies and investors from their own mistakes. We can, however, reasonably hope that boardroom sins of commission or omission – whether strategy, performance or oversight – are minimised. This Review, by focusing on the quality of non-executive directors and the boardroom climate and behaviours necessary for their success, will I hope help take us towards this goal.
- 1.11 Whereas in the US most governance discussion has focused on corporate malpractice, in the UK sharp loss of shareholder value is more common than fraud or corporate collapse. The fall in stockmarkets in the period 2000-2002 has thrown up some stark examples. In recent cases of corporate under performance in the UK, the role of the board, and of non-executive directors in particular, has understandably been called into question.
- 1.12 This Review therefore focuses as much on enhancing the competence and effectiveness of boards in promoting business prosperity as on issues of accountability. My view of the role of the non-executive director in this process contrasts with that of US regulators, who have tended to emphasise the monitoring role at the possible expense of the contribution the non-executive director can make to wealth creation. These two roles are, I believe, complementary and should be seen as such.
- 1.13 While it is not my conclusion that the UK framework of corporate governance is seriously flawed, it can clearly be improved. My view – echoed in many submissions – is that progressive strengthening of the existing architecture is strongly desirable, both to increase corporate accountability and to maximise sustainable wealth creation.
- 1.14 I do not believe, however, that legislation is the way forward. Instead, this Review builds on the “comply or explain” approach established by Sir Adrian Cadbury a decade ago. Listed companies have to report on how they apply the Code’s principles and to state whether they comply with the detailed provisions and, if not, why not. This approach has worked well.
- 1.15 Many boards have responded to the challenges of an increasingly competitive international environment by introducing, voluntarily, corporate governance standards and structures that go some way beyond the letter of the Code. As research undertaken for the Review shows, the norms of corporate governance behaviour in some areas are already well in excess of the Code’s



principles of best practice. On the other hand, compliance with the provisions of the Code varies appreciably across the listed sector. Whilst the best exceed, some still fall a long way short of the minimum expectations articulated by Cadbury a decade ago.

- 1.16 Institutional investors have an important role to play here. The Myners Review of institutional investment expressed concern over the reluctance of institutional investors to tackle corporate underperformance in companies in which they invest. This Review builds on the findings of the Myners Review.
- 1.17 In formulating my proposals, I have been mindful that compliance with the Code is not an end in itself, but a means of optimising corporate performance in the interests of shareholders and the economy. Good corporate governance must be an aid to productivity, not an impediment. It is an integral part of ensuring successful corporate performance, but of course only a part. It remains the case that successful entrepreneurs and strong managers, held properly to account and supported by effective boards, drive wealth creation.
- 1.18 Effective boards depend as much on behaviours and relationships as on procedures and structures. My recommendations reflect this, setting out the types of behaviours I believe are more likely to create the conditions that facilitate individual and overall board effectiveness.
- 1.19 I do not presume a “one size fits all” approach to governance is appropriate. There will always be exceptions, but this does not negate the need to establish the expected norm and put the onus on companies who consider themselves exceptions to explain why. The Review is not a blue-print for box-tickers, but a counsel of best practice that can be intelligently implemented with discretion.
- 1.20 People are the key. Critical to improving the effectiveness of non-executive directors is raising the quality of appointees. The evidence collected for the Review shows that the current population of non-executive directors is narrowly drawn. An open, fair and rigorous appointment process is essential to a successful board.
- 1.21 The Review thus sets out an agenda for change that builds on the existing Code of corporate governance best practice, clarifies the role of the non-executive director, fosters a relentless meritocracy in appointments, and seeks to create the conditions that will maximise their effectiveness.
- 1.22 In the Review, I have consciously focused on corporate governance arrangements in the UK listed sector, since it is to those companies that the Code applies. I recognise that a number of my recommendations may also be relevant to other companies and organisations and I hope that the Review will therefore be of wider interest and use.



# RECENT DEVELOPMENTS

## UK

- 2.1 In February 2002, alongside this Review, the Secretary of State for Trade and Industry and the Chancellor set up the Co-ordinating Group on Audit and Accounting Issues (CGAA) to review the UK audit and accounting regime. The final report of the CGAA is expected to be published shortly.
- 2.2 The interim report of the CGAA, published in July, commissioned a separate group, under the auspices of the FRC, to develop existing Code guidance for audit committees. The group, chaired by Sir Robert Smith, reports today. Their work, undertaken by expert practitioners, is welcome and makes strong and sensible guidelines to help audit committees increase their effectiveness. I have liaised closely with this group and their recommendations for the Code have been incorporated into the suggested new draft Code, at Annex A.
- 2.3 As the research for this Review shows, listed investment companies have a somewhat different board composition from other companies. They are subject to the comply and explain requirements in relation to the Code in the same way as other listed companies but are also subject to additional provisions in the listing rules. The listing rules are currently being reviewed.<sup>1</sup>
- 2.4 This Review also takes place in the context of the Government's fundamental revision of British company law (the Company Law Review). A three-year review was launched in 1998 to develop a simple, modern, efficient and cost-effective company law framework. The Review's final report was presented to the Secretary of State for Trade and Industry in July 2001. In July 2002, the Government published a White Paper "Modernising Company Law" which makes proposals for company law reform. This includes a codification of the general duties of directors.

## Europe

- 2.5 Across Europe, there has been much activity to strengthen corporate governance and company law standards, for example the Cromme Code in Germany and the Bouton Report in France. Their recommendations are broadly consistent with my own.
- 2.6 In November last year, the High Level Group of Company Law Experts, set up by the European Commission and chaired by Jaap Winter, reported on company law and corporate governance in the European Union (EU). The group did not propose a European harmonisation of approaches to corporate governance but called for Member States to have in their company law or national corporate governance codes minimum expected requirements. Member States would remain free to decide how to implement these standards in their jurisdiction.

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<sup>1</sup> FSA Review of the Listing Regime, July 2002.

- 2.7 In many areas, the UK corporate governance regime already meets the proposals in the High Level Group report. Recommendations for revising the Code in this Review will strengthen UK corporate governance standards still further.

## US

- 2.8 A number of submissions commented on the speed and direction of reform in US corporate governance reflected in the Sarbanes-Oxley legislation and the new listing rules. In contrast to the EU, US regulators have adopted a legislative approach in requiring higher standards of transparency, direct accountability on the part of the chief executive officer, and a greater degree of independence in the boardroom.
- 2.9 At the heart of US corporate governance is a concentration of decision making autonomy in one individual, the chairman and chief executive officer. Only around one fifth of US listed companies separate these roles. In contrast, separation is now common practice in the UK and I believe this is one of the core strengths of the UK corporate governance framework.
- 2.10 The US and Europe have responded in markedly different fashion to the challenge of tightening corporate governance regimes to restore public and investor confidence. The European approach, to strengthen best practice guidelines in the explicit recognition that corporate governance systems differ, is most welcome. My hope is that legislators continue to recognise the benefits of a flexible framework with the potential to adapt over time.

## CONDUCT OF THE REVIEW

- 3.1 My terms of reference required me to build and publish an accurate picture of the status quo, to lead a debate on the issues, and to make such recommendations as I thought appropriate to clarify the role and increase the effectiveness of non-executive directors. In June 2002, I published a consultation paper inviting responses to the central issues under consideration in the Review. Around 250 responses were received. The majority are available publicly on the Department of Trade and Industry website ([www.dti.gov.uk/cld/non\\_exec\\_review](http://www.dti.gov.uk/cld/non_exec_review)). I have also had a significant number of meetings with representative bodies and groups of interested individuals.
- 3.2 Three substantial pieces of primary research were also commissioned to inform my recommendations.
- 3.3 Firstly, data supplied by Hemscoff Group Limited (Hemscoff) and analysed by the Review team was used to build up a detailed picture of the population of non-executive directors in UK listed companies, as at July 2002. The research includes detailed information on the size, composition and membership of the board and committees of the 2,200 UK listed companies and the age and gender of their directors.
- 3.4 In addition, 605 executive directors, non-executive directors, and chairmen of UK listed companies were also surveyed by MORI in August 2002. The survey offers supplementary information on the role of non-executive directors including, for example, recruitment and induction processes and the existence and effectiveness of individual and collective performance appraisal.
- 3.5 Finally, 40 directors of FTSE 350 boards<sup>1</sup> were interviewed at length to gain an insight into the relationships and behaviours that enable effective non-executive director performance. Academics who are well-known in this field, Dr Terry McNulty of the University of Leeds and Dr John Roberts and Dr Philip Stiles of the University of Cambridge, conducted this research. Their report analyses the behaviours which promote effectiveness and looks in detail at the behavioural dynamics inside and outside the boardroom.
- 3.6 These three pieces of research are of broad interest and I encourage their widespread dissemination and use. I have drawn on the findings in the text of the Review. The full research can be found on the Review's website.
- 3.7 In addition, interviews were carried out on my behalf with a number of directors of small and mid-cap (outside the FTSE 350) companies, of institutional investors and search consultants.

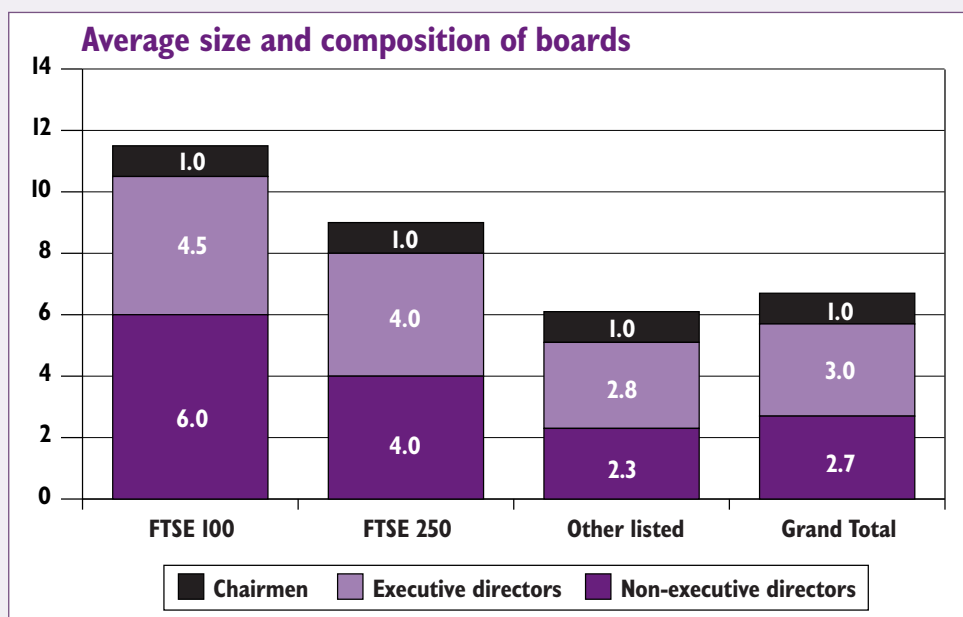
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<sup>1</sup> The FTSE 350 comprises the top 350 UK listed companies by market capitalisation.

## The current population of non-executive directors

As part of the Review, research was undertaken to build a factual picture of the current population of non-executive directors. The data<sup>1</sup> presented below is a summary of this research. The full analysis is on the Review's website ([www.dti.gov.uk/cld/non\\_exec\\_review](http://www.dti.gov.uk/cld/non_exec_review)). It should be noted that the data was drawn on 17th July 2002 and so reflects the situation at that time.

There are 5,172 **executive**, 4,610 **non-executive** and 1,689 **chairmen** posts held by directors in UK listed companies<sup>2</sup>.



Of the 3,908 individuals who hold non-executive directorships in UK listed companies, 80 per cent hold only one non-executive director post in a UK listed company, one in ten hold two non-executive posts in UK listed companies and seven per cent also hold an executive directorship. 13 per cent of chairmen hold more than one chairmanship. 282 individuals hold both executive and non-executive director posts in UK listed companies.

Five FTSE 100 companies and 11 per cent of companies outside the FTSE 350 companies have a **joint chairman/chief executive**. 24 FTSE 100 chairmen were **formerly the chief executive of the same company**.

Four per cent of executive director posts and six per cent of non-executive director posts are held by **women**. Less than one per cent of chairmen are female. In the telephone survey, which was a representative sample of directors in UK listed companies, seven per cent of non-executive directors were **not British** and one per cent were from **black and ethnic minority groups**.

The **average age** of a non-executive director in the FTSE 100 is 59, with over three-quarters 55 or over. The average age of a FTSE 100 chairman is 62. Almost 40 per cent are 65 or over.

The **average remuneration** of a FTSE 100 non-executive director is £44,000 p.a. and £23,000 p.a. for a non-executive director of a company outside the FTSE 350. The average remuneration of a FTSE 100 chairman is £426,000 p.a. (compared to an average of £78,000 p.a. for a chairman of a company outside the FTSE 350).

The **average time in post** was 4.3 years for a FTSE 100 non-executive director and 4.5 years for a non-executive director in a company outside the FTSE 350. This implies that the average tenure of non-executive directors of UK listed companies is significantly longer than four years. The average time on the board for a FTSE 100 chairman was about eight years. For a chairman of a company outside the FTSE 350, the average time was about seven years.

Most listed companies have an **audit committee** and a **remuneration committee**. One FTSE 100 company does not have an audit or a remuneration committee and 15 per cent of companies outside the FTSE 350 do not have an audit committee.

The majority (71 per cent) of companies outside the FTSE 350 do not have a **nomination committee**. Six FTSE 100 companies do not have a nomination committee.

**Investment companies**<sup>3</sup> have a different structure as their boards typically consist of a manager together with non-executive directors. On average their boards have five members. They have therefore not been included in the main analysis. Further data on them can be found on the website.

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<sup>1</sup> The data was supplied by Hemscott and analysed by the Review Team. Further and fuller details are available on the Review website.

<sup>2</sup> There are 1,702 listed companies in the UK, excluding investment companies (other than 3i).

<sup>3</sup> There are 480 investment companies listed in the UK (excluding 3i).

3.8 I am most grateful for the many very thoughtful consultation responses that I received and for the time generously given by all those who participated in the survey, interviews and meetings. It is striking, and encouraging, that there is a high degree of consensus on corporate governance issues generally in the UK, and on what is needed to strengthen the role and effectiveness of non-executive directors. I have drawn broadly on this consensus in framing my recommendations.





# ROLE OF THE BOARD

## **The role of the board**

The board is collectively responsible for promoting the success of the company by directing and supervising the company's affairs.

The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed.

The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives, and review management performance.

The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

(Suggested Code principle A.1 and provision A.1.1).

- 4.1 The role and the effectiveness of the non-executive director needs to be considered in the context of the board as a whole.
- 4.2 In the unitary board structure, executive and non-executive directors share responsibility for both the direction and control of the company. The benefit of the unitary board, strongly supported in consultation responses, is the value of executive knowledge within the board, alongside non-executive directors who can bring wider experience. Increasing the effectiveness of non-executive directors, while preserving the benefits of the unitary board, is a principal objective of the Review.
- 4.3 In contrast, the European system of corporate governance typically separates legal responsibility for running the company between a management and a supervisory board. In the US, the board is composed largely of non-executive ("outside") directors with only a few executives. Evidence collected during the Review has not convinced me of the merits of moving away from the unitary board structure in the UK.
- 4.4 In the UK, the general legal duties owed to the company by executive and non-executive directors are the same. All directors are required to act in the best interests of the company. Each has a role in ensuring the probity of the business and contributing to sustainable wealth creation by the company as a whole.
- 4.5 Included in the Companies White Paper<sup>1</sup> is a draft statutory statement of directors' duties to act, subject to the company's constitution, to promote

<sup>1</sup> "Modernising Company Law – Draft Clauses" (clause 19, schedule 2) published July 2002 TSO.

the success of the company for the benefit of its shareholders as a whole. In determining how best to promote the success of the company, directors must where relevant take account of “material factors”. As set out in the draft statutory statement, these include long as well as short term consequences of their actions, the need to foster business relationships, including with employees, suppliers and customers, impact on communities and the environment, business reputation and fairness between different shareholders.

- 4.6 The Code requires every listed company to be headed by an effective board which should lead and control the company. **I recommend that the Code should include more detailed provision on the board’s role, building on the principle in the Companies White Paper proposals, as set out in the box at the beginning of this Chapter** (suggested Code provision A.1.1).
- 4.7 A greater understanding of how a board operates is likely to create greater confidence amongst shareholders and others in the leadership and governance of a company. Information on the number of board and committee meetings held, and on attendance by individual directors, is not routinely published by all companies and would help shareholders judge the extent of directors’ participation.
- 4.8 Recognising that companies differ, both in the detailed role of the board and in the specific circumstances in which they operate, **I recommend that individual boards should publish in the annual report a statement describing how the board operates. This should include a high level statement of which decisions are taken by the board and those which are delegated to management** (suggested Code provision A.1.3). **The number of meetings of the board and of each of its established committees should be stated in the annual report, together with attendance by individual directors** (suggested Code provision A.1.2).
- 4.9 The board needs to be an effective decision-making body. Its size is an important factor. Several submissions expressed concern about the effective functioning of boards that are excessively large or small. Currently, the average size of the board of a UK listed company is seven, comprising three executive and three non-executive directors and a chairman. A FTSE 100 board is generally bigger with an average of 12 members, of whom six are non-executive directors, five are executive directors and one is the chairman. Nearly half FTSE 100 boards have 12 or more members. The trend has been towards smaller boards which I welcome.
- 4.10 **An effective board should not be so large as to become unwieldy. It should be of sufficient size that the balance of skills and experience is appropriate for the requirement of the business and that changes in the board’s composition can be managed without undue disruption** (suggested Code provision A.3.1).
- 4.11 Board membership and the conditions that help foster an effective board are discussed in Chapter 8.

# ROLE OF THE CHAIRMAN

## The role of the chairman

The chairman is responsible for:

- leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda;
- ensuring the provision of accurate, timely and clear information to directors;
- ensuring effective communication with shareholders;
- arranging the regular evaluation of the performance of the board, its committees and individual directors; and
- facilitating the effective contribution of non-executive directors and ensuring constructive relations between executive and non-executive directors.

(Suggested Code provisions A.2.5 and A.6.1).

- 5.1 The chairman is pivotal in creating the conditions for overall board and individual non-executive director effectiveness, both inside and outside the boardroom. I therefore examine the role of the chairman before considering that of the non-executive director. The particular nature of the chairman's role will inevitably be shaped by the challenges facing the company, its scale and complexity and the nature of its business. The role differs significantly from that of other non-executive and executive directors.
- 5.2 The chairman has the responsibility of leading the board in setting the values and standards of the company and of maintaining a relationship of trust with and between the executive and non-executive members. The Code already recognises the distinction between this role and that of the chief executive, whose task is to run the business under delegated authority from the board and to implement the policies and strategy set by the board. The Code currently requires public justification if the two roles are combined in one person.
- 5.3 There is already a high level of compliance with the Code's provision to separate the roles of chairman and chief executive, recommended by Cadbury a decade ago. Around 90 per cent of listed companies now split these roles. Separation of the roles of chairman and chief executive is one of the strengths of the UK corporate governance regime. It avoids concentration of authority and power in one individual and differentiates leadership of the board from running of the business. The benefits envisaged by Cadbury are now widely acknowledged. **I therefore propose that the Code contain a straightforward statement that the roles of chairman and chief executive should be separated** (suggested Code provision A.2.1).

- 5.4 A strong relationship between the chairman and chief executive lies at the heart of an effective board. As set out in the research conducted for the Review, the relationship works best where there is a valuable mix of different skills and experiences which complement each other. The chairman should not seek executive responsibility and should let the chief executive take credit for their achievements. The chairman can be an informed, experienced and trusted partner, the source of counsel and challenge designed to support the chief executive's performance, without becoming an obstacle to questioning of the chief executive by the non-executive directors. The separation of roles can contribute to the greater achievement of the chief executive as well as being important in creating the conditions for effective performance by the non-executive directors.
- 5.5 **The division of responsibilities between the chairman and chief executive should be set out in writing and agreed by the board** (suggested Code provision A.2.1).
- 5.6 My research also highlighted the potential difficulties of the chairman being a former chief executive of the same company. Having been responsible for the day-to-day running of the company and with the detailed knowledge of it that this brings, such a chairman can sometimes find it difficult in practice to make room for a new chief executive. In addition, a chairman who was formerly the chief executive of the same company may simply take for granted their inside knowledge and fail as an informational bridge to the non-executive directors.
- 5.7 For these reasons, it is generally undesirable for the chief executive of a company to become chairman of its board. Over three-quarters of FTSE 100 companies currently have a chairman who was not formerly the chief executive. **I recommend that the Code should provide that a chief executive should not become chairman of the same company** (suggested Code provision A.2.3).
- 5.8 The chairman needs to foster relationships of trust with both the executive and non-executive directors on the board, whilst at the same time maintaining support for, and partnership with, the chief executive. A degree of detachment from the executive can also be valuable in ensuring objective debate on strategy and other matters. For these reasons my view is that **at the time of appointment the chairman should meet the test of independence** (suggested Code provision A.2.4). Chapter 9 explains in more detail the benefits independence can bring to the board.
- 5.9 Once appointed, the chairman will have a much greater degree of involvement with the executive team than the non-executive directors. Applying a test of independence at this stage is neither appropriate nor necessary.

- 5.10 A chairman who is not full-time is sometimes described as being a “non-executive chairman”. This description is unhelpful. An effective chairman will spend as much time as needed to fulfil their role and is best described simply as “chairman”. The title “executive chairman”, on the other hand, connotes additional executive powers and should only be used consciously and in those circumstances, for example of temporary and unexpected transition between chief executives, where it is not possible to meet the relevant provisions of the Code for separation of the roles of chairman and chief executive.
- 5.11 The board agenda must take full account of the issues and concerns of all board members for the board to be effective. This is the chairman’s responsibility. The chairman should also make efficient use of board time by ensuring that board agendas are forward looking and concentrate on strategy, rather than approving proposals which should be decided by management.
- 5.12 The chairman is responsible for managing the business of the board to ensure that sufficient time is allowed for discussion of complex or contentious issues and, where appropriate, arranging for informal meetings beforehand to enable thorough preparation for the board discussion. It is particularly important that non-executive directors have sufficient time to consider critical issues and are not faced with unrealistic deadlines for decision-making.
- 5.13 As the role of the chairman is so central to realising the potential of the unitary board, a number of respondents to the consultation requested further guidance on the role of the chairman. Annex D describes some of the attributes and behaviours of an effective chairman.



# ROLE OF THE NON-EXECUTIVE DIRECTOR

## Role of the Non-Executive Director

**Strategy:** Non-executive directors should constructively challenge and contribute to the development of strategy.

**Performance:** Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

**Risk:** Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.

**People:** Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning.

(Suggested Code provision A.1.4).

- 6.1 The role of the non-executive director is frequently described as having two principal components: monitoring executive activity and contributing to the development of strategy. Both Cadbury and Hampel identified a tension between these two elements.
- 6.2 Research commissioned for the Review drew a somewhat different conclusion. Based on 40 in-depth interviews with directors, the research found that while there might be a tension, there was no essential contradiction between the monitoring and strategic aspects of the role of the non-executive director. Polarized conceptions of the role, the research noted, bear little relation to the actual conditions for non-executive effectiveness. An overemphasis on monitoring and control risks non-executive directors seeing themselves, and being seen, as an alien policing influence detached from the rest of the board. An overemphasis on strategy risks non-executive directors becoming too close to executive management, undermining shareholder confidence in the effectiveness of board governance.
- 6.3 The research concludes that it is important to establish a spirit of partnership and mutual respect on the unitary board. This requires the non-executive director to build recognition by executives of their contribution in order to promote openness and trust. Only then can non-executive directors contribute effectively. The key to non-executive director effectiveness lies as much in behaviours and relationships as in structures and processes.
- 6.4 The Code currently offers no guidance on the role of the non-executive director. The lack of clarity about the role has been a recurrent theme in submissions to the Review and in the interviews with directors. In part, this may be due to the tensions implicit in the role and uncertainty on how best to manage the various relationships. Companies of course differ, in terms of scale, diversity and complexity and in what they require from their boards.

Nonetheless, consultation suggested that clarifying the core elements of the role would be helpful.

- 6.5 Executive and non-executive directors have the same general legal duties to the company. However, as the non-executive directors do not report to the chief executive and are not involved in the day-to-day running of the business, they can bring fresh perspective and contribute more objectively in supporting, as well as constructively challenging and monitoring, the management team.
- 6.6 Non-executive directors must constantly seek to establish and maintain their own confidence in the conduct of the company, in the performance of the management team, the development of strategy, the adequacy of financial controls and risk management, the appropriateness of remuneration and the appointment and replacement of key personnel and plans for management development and succession. The role of the non-executive director is therefore both to support executives in their leadership of the business and to monitor and supervise their conduct.
- 6.7 **I therefore propose that a description of the role of the non-executive director be incorporated into the Code as set out in the box at the beginning of this Chapter** (suggested Code provision A.1.4). This definition brings together the essential elements of the role identified in consultation responses and research.
- 6.8 In practice, non-executive directors will pursue some of their activities through their role on board committees. In smaller companies, non-executive directors may also often provide specific expertise or experience to complement that of the executive team which may be valuable in coaching and supporting management.

## The behaviours and personal attributes of the effective non-executive director

- 6.9 The non-executive director role is complex and demanding and requires skills, experience, integrity, and particular behaviours and personal attributes.
- 6.10 Non-executive directors need to be sound in judgement and to have an inquiring mind. They should question intelligently, debate constructively, challenge rigorously and decide dispassionately. And they should listen sensitively to the views of others, inside and outside the board.
- 6.11 In order to fulfil their role, non-executive directors must acquire the expertise and knowledge necessary properly to discharge their responsibilities. They must be well-informed about the business, the environment in which it operates and the issues it faces. This requires a knowledge of the markets in which the company operates as well as a full understanding of the company itself. Understanding the company is essential to gain credibility and reduce the inevitable disparity in knowledge between executive and non-executive directors. Developing such knowledge cannot be done within the confines of the boardroom alone.



- 6.12 A number of consultation responses identified the personal attributes required of the effective non-executive director. They are founded on:
- integrity and high ethical standards;
  - sound judgement;
  - the ability and willingness to challenge and probe; and
  - strong interpersonal skills.
- 6.13 First and foremost, integrity, probity and high ethical standards are a prerequisite for all directors.
- 6.14 Second, sound judgement is central to the non-executive director's role. This is essential for each of the elements of the non-executive director's role I have set out above.
- 6.15 Third, all non-executive directors must be able and willing to inquire and probe. They should have sufficient strength of character to seek and obtain full and satisfactory answers within the collegiate environment of the board. The objectivity and fresh perspective acquired through their relative distance from day-to-day matters, combined with experience acquired elsewhere, is the basis for questioning and challenging the accepted thinking of the executive.
- 6.16 Questioning does not only serve to raise specific concerns, it can also prompt stronger executive performance. Skilful questioning can be penetrating and demanding. The response can both reassure the non-executive director and stimulate reflections and actions that contribute to more effective executive performance. Executive directors especially value informed and constructive debate with non-executive directors.
- 6.17 Fourth, strong interpersonal skills are an essential characteristic of the effective non-executive director. Much of their effectiveness depends on exercising influence rather than giving orders and requires the establishment of high levels of trust.
- 6.18 Inevitably, the effectiveness of a non-executive director's contribution will change over time. Non-executive directors should be willing and able to acknowledge when their individual contribution is no longer fresh, and should make way for newcomers in an orderly and managed way.
- 6.19 The term "non-executive director", focuses on what they are not rather than what they are. Other terms have been suggested. "Outside director" is a term used in the US and elsewhere but it is not widely recognised in the UK. The term "independent director" is given a particular meaning in this Review, and by no means all non-executive directors could, or need to, meet it. I do not suggest a change in the term.



## THE SENIOR INDEPENDENT DIRECTOR

- 7.1 Currently, the Code envisages a role for a senior independent non-executive director (senior independent director) whether or not the roles of chairman and chief executive are combined.
- 7.2 Responses to consultation contained a range of views on the identification of a senior independent director. Some saw the role as unnecessary or divisive. It was pointed out that shareholders may make use of their own connections with non-executive directors, or contact the chairmen of board committees, if they have concerns.
- 7.3 Most respondents, however, supported the concept of a senior independent director, noting the importance of sensitivity in the conduct of the role. I agree with them.
- 7.4 **I therefore endorse the Code provision that a senior independent director be identified.** They should of course meet the test of independence set out in this report. Unless it is anticipated that they will become chairman, and provided they meet the test of independence, the role could be assumed by the deputy chairman, if there is one.
- 7.5 I see the role of the senior independent director as important in the relationship between major shareholders and the board, as set out in paragraphs 15.15 and 15.16. **The senior independent director should be available to shareholders, if they have reason for concern that contact through the normal channels of chairman or chief executive has failed to resolve** (suggested Code provision A.3.6). **The senior independent director should also chair meetings between non-executive directors where the chairman does not attend** (suggested Code provision A.1.5), discussed below.



# THE EFFECTIVE BOARD

- 8.1 Many submissions to my consultation identified a set of key characteristics of an effective unitary board. A chairman who has a strong, complementary relationship with the chief executive and the members of the board is a central element of an effective board, as already described. A culture of openness and constructive dialogue in an environment of trust and mutual respect is also a prerequisite for an effective board. The chairman has a central role to play in fostering these conditions through their own actions and through engagement with the members of the board.
- 8.2 The research I commissioned found that confidence in executive conduct is not achieved once and for all but rather through continuous active engagement of the non-executive directors with the executive in all aspects of the board's work. There is the potential for a virtuous dynamic in which executive perceptions of the value of non-executive directors' experience and contribution encourages greater executive openness that, in turn, allows for greater non-executive engagement. Inappropriate or ill-formed non-executive contributions can quickly break this virtuous dynamic, by leading to executive frustration or defensiveness and attempts to minimise the role of the non-executive directors. In turn this feeds the non-executive directors' suspicion of executive directors.
- 8.3 The culture of the boardroom can also benefit significantly from a planned programme of recruitment and retirement of board members, discussed in Chapter 10.
- 8.4 Many submissions emphasised the need for both a proper balance of skills and experience and the need for boards to include both executive and non-executive directors in the boardroom, such that no one group or individual dominates. My research shows that the overwhelming majority of boards exceed the current Code requirement for one-third of the board to be non-executive. One FTSE 100 board and 14 per cent of FTSE 250<sup>1</sup> boards are less than one-third non-executive. A higher proportion of smaller listed boards (34 per cent) do not meet the Code's guidelines.
- 8.5 On average, non-executive directors comprise around half a FTSE 100 board. In smaller listed companies, the non-executive directors on average comprise just over a third of the board.
- 8.6 It is important to ensure that the board as a whole is well informed about the company. At present, most larger company boards have a significant executive representation on the board. Only 12 FTSE 100 companies have fewer than three executive directors on the board. There is a greater risk of distortion or withholding of information, or lack of balance in the management contribution to the boardroom debate, when there is only one or a very small number of executive directors on the board. **For this reason, I recommend that the Code provides that there should be a strong executive representation on the board** (suggested Code provision A.3.2).

<sup>1</sup> The FTSE 250 comprise the 250 most highly capitalised companies outside the FTSE 100 (i.e. from the 101st largest by market capitalisation to the 350th largest by market capitalisation).

- 8.7 A number of submissions suggested that non-executive directors should meet on their own to increase their effectiveness and to allow for more organised discussion of issues of governance and overall performance. The New York Stock Exchange (NYSE) listing rules published last year require independent directors to meet regularly at scheduled sessions without management present. Their regular scheduling helps prevent any negative inference being drawn from the occurrence of the meetings.
- 8.8 I agree that it is helpful for non-executive directors to have such meetings without executive directors present, and on occasion without the chairman present. Such discussions are informal and do not replace other discussions between the board as a whole. They should not be seen to signal a problem. But they can allow concerns to be raised and shared on matters such as the provision of information or succession planning. **I therefore propose that the non-executive directors should meet as a group at least once a year without the chairman or executive directors present. There should be a statement in the annual report on whether the non-executive directors have met without the chairman or executives present** (suggested Code provision A.1.5). There may be a case for additional meetings of the non-executive directors together with the chairman.

## INDEPENDENCE

- 9.1 A major contribution of the non-executive director is to bring wider experience and a fresh perspective to the boardroom. Although they need to establish close relationships with the executives and be well-informed, all non-executive directors need to be independent of mind and willing and able to challenge, question and speak up. All non-executive directors, and indeed executive directors, need to be independent in this sense.
- 9.2 At least a proportion of non-executive directors also need to be independent in a stricter sense. There is natural potential for conflict between the interests of executive management and shareholders in the case of director remuneration, or audit (where decisions on the financial results can have a direct impact on remuneration), or indeed in a range of other instances.
- 9.3 Although there is a legal duty on all directors to act in the best interests of the company, it has long been recognised that in itself this is insufficient to give full assurance that these potential conflicts will not impair objective board decision-making.
- 9.4 Requiring a greater degree of independence on boards has been a central theme in the recent US corporate governance reform measures. The Sarbanes-Oxley Act requires all members of the audit committee to be independent. Under the new NASDAQ listing rules and the new NYSE listing rules, a majority of the board must be independent. The Bouton report on corporate governance in France also recommended that half the board should be independent.
- 9.5 I agree with the conclusions of these reports that a board is strengthened significantly by having a strong group of non-executive directors with no other connection with the company. These individuals bring a dispassionate objectivity that directors with a closer relationship to the company cannot provide. In the light of the need to manage conflict of interests, the increasing role of the board committees, and the positive benefits of independence, **I recommend that the Code should provide that at least half of the members of the board, excluding the chairman, should be independent non-executive directors** (suggested Code provision A.3.5). I recognise that practical considerations mean that widespread compliance with this recommendation may take time to achieve.
- 9.6 The recommendation should not, however, be interpreted as meaning that non-executive directors who have a recent or existing connection of some kind with the company have no place on the board. They may indeed be valuable, but they should be additional to the requisite proportion of independent non-executive directors.

## Definition of independence

- 9.7 The Code currently provides that the majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement, leaving it to boards to identify which of its non-executive directors are considered to meet this test.
- 9.8 This definition gives little guidance to companies as to what the test should entail. Shareholder bodies, in particular, have drawn up their own definitions against which appointments are assessed. There are over a dozen such definitions in the UK, all with different criteria. This proliferation of definitions is, I believe, unhelpful. What is needed is a set of guidelines which can be intelligently and consistently applied.
- 9.9 I have considered carefully the different definitions which are applied in different jurisdictions and by various bodies in the UK, together with the different approaches provided in response to consultation. I am not convinced by the case, made in some submissions, that independence should be defined in statute.
- 9.10 On the basis of my work, **I recommend that it should be a provision of the Code that all directors have to take decisions objectively in the interests of the company** (suggested Code provision A.3.3). That is the existing legal position, but it is valuable to state it clearly as it is a fundamental feature of the unitary board. Requiring some board members to be more obviously free from other connections with the company would thus not be seen as reducing the need for independence of mind from all of them.
- 9.11 **I also recommend including in the Code a definition of independence** (suggested Code provision A.3.4), which I hope will replace the current multitude of definitions which many consultation responses regretted. This proposed new definition addresses not just relationships or circumstances that would affect the director's objectivity, but also those that could appear to do so.
- 9.12 I very much hope that business and investor bodies will endorse this new definition so that, for the first time, there is a widely accepted definition of director independence.
- 9.13 When a director is proposed for appointment or re-appointment, the board should state whether they are to be regarded as meeting the test of independence. It is the responsibility of the whole board to produce the statement, and for the individual director to ensure its accuracy.
- 9.14 The definition makes it clear that receiving additional remuneration beyond the director's fee compromises an individual's independence. In addition, it is important that a non-executive director is not so dependent on the income from their role or shareholding as to prejudice independence of judgement, and I would expect boards to take this into account in determining independence. Remuneration is discussed in Chapter 12.



## Independence

A non-executive director is considered independent when the board determines that the director is independent in character and judgement and there are no relationships or circumstances which could affect, or appear to affect, the director's judgement.

Such relationships or circumstances would include where the director:

- is a former employee of the company or group until five years after employment (or any other material connection) has ended;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than ten years.

The board should identify in its annual report the non-executive directors it determines to be independent. The board should state its reasons if a director is considered to be independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination.

(Suggested Code provision A.3.4).



# RECRUITMENT AND APPOINTMENT

- 10.1 Ensuring that the board as a whole has an appropriate mix of skills and experience is essential for it to be an effective decision-making body. There is no “standard” board or “standard” non-executive director, nor can there be. It is the range of skills and attributes acquired through a diversity of experiences and backgrounds that combine to create a cohesive and effective board. The balance of skills and experience required inevitably changes to reflect the changing needs of the business.
- 10.2 Identifying individuals of suitable quality and background is essential for a high performing board. The nominations and appointments process is crucial to strong corporate performance as well as effective accountability.

## The nomination and appointment process

- 10.3 The Code currently offers guidance on the nomination and appointment process. It provides for a nomination committee to make recommendations to the board on all new board appointments unless the board is small. A majority of the members of this committee should be non-executive directors.
- 10.4 Almost all FTSE 100 companies have a nomination committee, compared to only 30 per cent of companies outside the FTSE 350. However, interviews conducted for the Review suggested that where the nomination committee does exist it is the least developed of the board’s committees, usually meeting irregularly and often without a clear understanding of the extent of its role in the appointment process. In some cases, board members who are not committee members are present at committee discussions, effectively making the committee indistinct from the board as a whole.
- 10.5 A high level of informality surrounds the process of appointing non-executive directors. Almost half of the non-executive directors surveyed for the Review were recruited to their role through personal contacts or friendships. Only four per cent had had a formal interview, and one per cent had obtained their job through answering an advertisement. This situation was widely criticised in responses to consultation, and I accept that it can lead to an overly familiar atmosphere in the boardroom.
- 10.6 I have considered whether lessons can be learnt from the appointments and nominations process in the public sector, where there is a clear requirement to appoint on merit set out in the Nolan Principles. Recruiting or nominating committees are typically set up and draw up a comprehensive job or role description. Best practice is that essential and desirable competencies are identified before candidates are approached. Advertising of roles is considered good practice, often alongside other forms of search.
- 10.7 I was also told that voluntary and charitable organisations are increasingly making use of formal recruitment processes, including the use of advertising,

search consultants and external agencies, to appoint trustees. The Association of Chief Executives of National Voluntary Organisations (ACEVO) promotes as good practice the completion of a skills audit prior to any appointment alongside an open recruitment process and a clear statement on term of office.

10.8 I believe that a rigorous, fair and open appointments process is essential to promote meritocracy in the boardroom and that existing best practice for nominating and appointing directors should be universally adopted.

10.9 I recommend that:

- **All listed companies should have a nomination committee which should lead the process for board appointments and make recommendations to the board** (suggested Code provision A.4.1).
- **The nomination committee should consist of a majority of independent non-executive directors. It may include the chairman of the board, but should be chaired by an independent non-executive director** (suggested Code provision A.4.1).
- **The chairman and members of the nomination committee should be identified in the annual report and should make publicly available their terms of reference explaining clearly their role and the authority delegated to them by the board** (suggested Code provisions A.4.1 and A.4.2). Annex F provides specimen terms of reference for the nomination committee developed with the ICOSA. I am very pleased that ICOSA have agreed to keep the guidance under review in the future to reflect improvements in best practice.
- **Before making an appointment, the nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, should prepare a description of the role and capabilities required for a particular appointment** (suggested Code provision A.4.3).
- **A statement should be made in the annual report detailing the activities of the nomination committee and the process used for appointments. An explanation should be given if external advice or open advertising has not been used** (suggested Code provision A.4.10). **The number of committee meetings and individual attendance over the course of the year should be stated** (suggested Code provision A.1.2).
- **The nomination committee should ensure that on appointment, non-executive directors receive a formal letter of appointment setting out clearly what is expected of them in terms of time commitment, committee membership and involvement outside board meetings** (suggested Code provision A.4.4). A specimen letter of appointment is provided in Annex H.

- 10.10 As discussed in Chapter 12, **non-executive directors should disclose to the chairman the nature and extent of their other appointments and confirm that they will have available the time required for their role** (suggested Code provision A.4.6). During their period of office, non-executive directors should inform the chairman of any other appointments they take up (including the amount of time they will need to devote to them), and make the chairman aware of any changes to their other commitments which might impact on the time they can devote to the company's affairs. Once reported to the chairman, such matters should be formally recorded by the company secretary at the next board meeting.
- 10.11 It is important that shareholders have sufficient information on which to base approval of appointments. **I therefore recommend that, when an appointment of a non-executive director is put forward for approval to shareholders, the board should explain why they believe the individual should be appointed and how they meet the requirements of the role set out in Chapter 6** (suggested Code provision A.4.5).
- 10.12 Taken together, it is my hope that these recommendations will result in a nominations and appointments process that is rigorous, fair and transparent and promotes meritocracy in the boardroom.

## Succession planning

- 10.13 A planned programme of recruitment and retirement amongst board members can be of significant benefit. It is an important part of the board's work to ensure that there is adequate management development and succession planning. An often overlooked role for the nomination committee is to provide support on this. Succession planning should involve an assessment of the challenges and opportunities facing the company, and an evaluation of the skills and expertise that will be needed on the board in the future. Both executive and non-executive requirements should be considered. **The committee should satisfy itself that processes and plans are in place for orderly succession for appointments to the board and to senior management to maintain an appropriate balance of skills on the board. I recommend that the Code include reference to this important role for the nomination committee** (suggested Code provision A.4.9).
- 10.14 More also needs to be done to develop the directors of the future. **Chairmen and chief executives should consider implementing executive development programmes to train and develop suitable individuals for future director roles.**

## The pool of non-executive directors

- 10.15 It is generally assumed that business experience is important for a non-executive director. I believe, however, that the qualities necessary for an effective contribution to the board can also be acquired from a variety of backgrounds. The interplay of varied and complementary perspectives amongst different members of the board can significantly benefit board performance.
- 10.16 The composition of a board sends important signals about the values of the company. A commitment to equal opportunities which can be of motivational as well as reputational importance is inevitably undermined if the board itself does not follow the same guiding principles.
- 10.17 In the research and consultation responses, evidence diverged on the extent to which there is a shortage of good people to take on non-executive roles. Part of the problem seems to be however that the supply of talent that does exist is not being sufficiently drawn upon.
- 10.18 One explanation is likely to be the attitudes of boards when considering appointments. A number of responses to the consultation identified a self-perpetuating tendency in the appointments process that militates against wider representation in the boardroom. Previous PLC board experience is often seen to be the main, and sometimes only, competence demanded of potential candidates. Too often due consideration is not given to candidates with a broader mix of skills and experience.
- 10.19 It has been suggested that search consultants have a tendency to identify candidates from a narrow pool of candidates. If that is so, nomination committees can and should insist that their consultants look beyond the “usual suspects” to find candidates who would make good board members.
- 10.20 It is clearly in the interests of the company to ensure that the best people are recruited to direct and supervise it. It is important that boards recognise their responsibility and appoint on merit.
- 10.21 My research shows that non-executives are typically white males nearing retirement age with previous PLC director experience. There are less than 20 non-executive directors on FTSE 100 boards under the age of 45. In the telephone survey for the Review, seven per cent of non-executive directors were not British, and one per cent were from black and ethnic minority groups.
- 10.22 The very low number of female non-executive directors is striking in comparison with other professions and with the population of managers in UK companies overall. Across the corporate sector as a whole, around 30 per cent of managers overall are female<sup>2</sup>. Only six per cent of non-executive posts are held by women, and there are only two female chairmen in the FTSE 350.

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<sup>2</sup> Labour Force survey (reference, EOC).

- 10.23 The diversity and mix of experience of public sector appointees is broader than in the private sector boardroom. In the year to 31 March 2002, of the 3,856 appointments and re-appointments to public bodies, 38 per cent were female (for chairmen, the proportion is slightly lower at 34 per cent) and nine per cent were from ethnic minorities.
- 10.24 Using personal contacts as a main source of candidates will tend to favour those with similar backgrounds to incumbent directors. A rigorous appointments process is important to offset this natural bias. The various criteria used for selection may also implicitly discriminate against women, such as requiring wide senior executive or PLC board experience.
- 10.25 Part of the reason for the small number of female directors may be that areas where women tend to be more strongly represented are in roles such as human resources, change management and customer care which are not regarded as traditional routes to the board. Yet the issues dealt with in such roles are important ones for the board, and the roles themselves encourage skills and attributes that are highly relevant to the boardroom. **I hope that in future boards will draw more actively from these groups when making appointments, even if the appointees are not yet at board level.**
- 10.26 Currently, few executive directors or talented individuals just below board level sit as non-executive directors in other companies. Of more than 5,000 executive directors in UK listed companies, currently 282 hold a non-executive director post in a UK listed company. There are many benefits of doing so. The company that employs the individual on a full-time basis will benefit from the individual gaining a broader perspective and developing skills and attributes relevant to any future role as a director. Conversely, the board of the company receiving the individual benefits from executive experience elsewhere. This encourages the sharing and disseminating of best practice.
- 10.27 **I therefore invite the chairmen of listed companies to encourage and facilitate their executive directors and suitable senior management just below board level to take one non-executive director position on a non-competitor board.**
- 10.28 Companies are increasingly operating across borders. International experience can bring an important dimension to a boardroom. **All companies operating in international markets could, I believe, benefit from having at least one international non-executive director with relevant skills and experience on their board.** In practice I have been told that candidates from jurisdictions where two-tier boards are prevalent sometimes have difficulty understanding the workings of a unitary board structure. I believe training on the distinctive characteristics of the unitary board structure and the behaviours needed to be effective in this context could play a role here.

- 10.29 **Lawyers, accountants and consultants are used to working in an advisory capacity to business and to analysing and learning about a business from the outside. As a non-executive director, they can bring a set of skills that are useful to the board.** Such groups contain a relatively high proportion of women. I would encourage these organisations to allow suitable candidates to take on non-executive director roles.
- 10.30 **Boards should also look to private companies, some of which are of significant scale, as a source of non-executive directors.** I would hope that private companies would look favourably on the experience that might thereby be gained by their directors.
- 10.31 The skills and experience gained through careers in the non-commercial sector can be highly relevant to a PLC boardroom. **There are individuals in charitable or public sector bodies who have developed strong commercial and market understanding. Including them on a PLC board can increase the breadth and diversity of experience that can in turn increase its effectiveness.**
- 10.32 The challenge is to provide greater opportunities for such individuals to be appointed. **I am therefore very pleased that a group of business leaders and others will be formed to help bring to greater prominence candidates from the non-commercial sector who could have the skills and experience to make an effective contribution to the boards of listed companies. The group will describe the profile of relevant skills and experience that make an effective non-executive director with a non-commercial background. A list will also be developed of around 100 individuals from the non-commercial sector. As women are more strongly represented at senior levels in the non-commercial sector, the expected outcome would be that a significant proportion would be female. The group will report to the Secretary of State for Trade and Industry in May.**
- 10.33 In order to address the perceived need for previous board experience, an option which some companies have found useful is to bring onto the boards of subsidiary companies talented individuals from wider and more diverse backgrounds, to give them exposure to the operation of a board as a possible stepping-stone to the board of a listed company.

## **Nominating and appointing chairmen**

- 10.34 An effective chairman, as described above, is critical to fostering a constructive boardroom environment. A number of respondents to my consultation expressed concern that it was difficult to find able people for this demanding and important role. I have no easy answers on how to widen the pool of potential chairmen, although the recommendations I have made to encourage a much stronger mix of non-executive directors should help.



10.35 Ensuring that the process for appointing the chairman is robust is an essential pre-condition for getting the right person in the role. **Three principles should be observed when a board is appointing a new chairman:**

- **The senior independent director or deputy chairman, if independent, should normally lead the appointment process.** The incumbent chairman should not assume this role. Clearly, any individual who is putting themselves forward as a candidate should not be involved in the appointment process. Although the decision is ultimately for the board as a whole, the group leading the process, if not the nomination committee, should comprise a majority of independent non-executive directors.
- **A systematic approach should be taken to identify the skills and expertise required for the role and a job specification prepared.**
- **A short-list of good candidates should be considered, rather than possible individuals being considered in turn.** The process will almost certainly benefit from external advice.



# THE WELL-INFORMED NON-EXECUTIVE DIRECTOR

## Induction

- 11.1 To be effective, newly appointed non-executive directors quickly need to build their knowledge of the organisation to the point where they can use the skills and experience they have gained elsewhere for the benefit of the company. **A comprehensive, formal and tailored induction should always be provided to new non-executive directors to ensure an early contribution to the board** (suggested Code provision A.5.6).
- 11.2 Responses to consultation showed a widespread acceptance of the importance of induction. However, the telephone survey showed that less than one quarter of non-executive directors received a formal briefing or induction after appointment.
- 11.3 Often it is left to new non-executive directors to take the initiative in seeking an induction programme and to ask the right questions in order to receive the right information. This is not acceptable.
- 11.4 **As part of running an effective board, companies need to set aside adequate resources and ensure sufficient time is allowed for a thorough induction for directors** (suggested Code provision A.5.7). **The chairman should take the lead in providing a properly constructed induction programme, facilitated by the company secretary.** It can be helpful for existing non-executive directors to give feedback on what they found useful. Induction programmes should be tailored to the company and the individual.
- 11.5 Non-executive directors interviewed for this Review reported that visiting company locations and attending company events, together with the informal contact with board and management that this brings, has significantly developed their knowledge of the business and its people. Opportunities should also be provided to ensure that non-executive directors see regularly, and at first hand, the performance of the senior management team. As guidance, the checklist at Annex I, developed with ICSA, provides guidance on the core elements of the induction process.

## Professional Development

- 11.6 On appointment, non-executive directors will already have relevant skills, knowledge, experience and abilities. Nonetheless a non-executive director's credibility and effectiveness in the boardroom will depend not just on their existing capability but on their ability to extend and refresh their knowledge and skills.

- 11.7 The telephone survey revealed that two-thirds of non-executive directors and chairmen had not received any training or development. Of those who said that they had, the training was often in the form of experience of business or being a member of a board, rather than any structured provision. It is questionable the extent to which this experience alone is sufficient to maintain up-to-date knowledge.
- 11.8 The word “training” in this context is not altogether helpful as it carries rather limited connotations of formal instruction in a classroom setting. Comments to the Review confirm this. By contrast, what I envisage is continued professional development tailored to the individual.
- 11.9 Potential directors need to understand the role of the board, obligations and entitlements of directors of listed companies and the behaviours needed for effective board performance. For foreign directors, the working of the unitary board could usefully be covered.
- 11.10 For existing directors, knowledge of issues such as strategy, management of human and financial resources, audit and remuneration can often usefully be updated and expanded. Updates on legal, regulatory and other obligations can also be helpful. In addition, revisiting the effective behaviours of a board director, such as influencing skills (which may be different for different purposes), conflict resolution, chairing skills and board dynamics can often be beneficial (see paragraphs 11.19 to 11.24).
- 11.11 My research confirmed that some non-executive directors were concerned about the increasing amount of technical knowledge necessary in order to fulfil their roles on board committees such as audit and remuneration. Others noted the value of training on issues such as risk management. There are also instances where mastery of complicated, fast-evolving financial products or technology is necessary for non-executive directors sensibly to appraise the suitability of a company’s strategy.
- 11.12 **I would expect that, as part of the evaluation process, non-executive directors should regularly appraise their individual skills, knowledge and expertise, and determine whether further professional development would help them develop their expertise and fulfil their obligations as members of the unitary board.**
- 11.13 Demand for formal training is very low. The relatively limited supply of training specifically aimed at non-executive directors by business schools and other providers may be a factor, but some such provision has been reduced because of poor take-up. Another factor may be that provision does not match the needs of non-executive directors. However it is also the case that an entrenched boardroom culture tends to regard non-executive directors as being fully equipped for the role without the need for any further personal development. In some cases this presumption may be justified; in most, it is not.

- 11.14 **Companies should acknowledge that to run an effective board they need to provide resources for developing and refreshing the knowledge and skills of their directors, including the non-executive directors** (suggested Code provision A.5.7). **The chairman should address the developmental needs of the board as a whole with a view to enhancing its effectiveness as a team.**
- 11.15 The chairman should also lead in identifying the development needs of individual directors, with the company secretary playing a key role in facilitating provision. Non-executive directors should be prepared to devote time to keeping their skills up-to-date.
- 11.16 Interviews conducted as part of the Review suggested that a case-study based approach using dynamic, real corporate life situations, such as mergers and acquisitions and risk management, may be as useful as a lecture-based approach. There are also a number of briefing programmes and networking groups through which non-executive directors and chairmen can share best practice information with their peers and refresh their knowledge. These programmes could usefully be developed, and non-executive directors should recognise the benefits of participating in them. Awareness of what is available should also be increased.
- 11.17 **It is my belief that there should be a step change in training and development provision so that it is suited to the needs of boards.**
- 11.18 More could also be done to ensure that the non-executive directors of the future are prepared for what is an increasingly complex and demanding role. Providers of MBA courses might consider the benefits of including elements on the behaviours and skills needed in the boardroom, as well as corporate governance and the role of the board, to prepare prospective board members at an earlier stage in their career.

## Performance evaluation

- 11.19 Every board should continually examine ways to improve its effectiveness. Boards can benefit significantly from formally reviewing both individual and collective board performance, including committees. Yet my research shows that over a third of boards never formally evaluate their own performance, while over three-quarters of non-executive directors and over half of chairmen never have a formal personal performance review.
- 11.20 The Code does not offer guidance on evaluating the performance of individual directors or of the board as a whole. It also has no specific guidance on dealing with under-performance, except for the recommendation that the re-appointment of non-executive directors should not be automatic.
- 11.21 The majority of submissions were in favour of the Code being modified to include guidance on conducting board and individual performance reviews. This view was supported in interviews with both directors and investors.

- 11.22 A board performance appraisal gives the chairman the information and confidence to manage the board more effectively. **It helps the chairman to identify and address the strengths and weaknesses of the board and consider whether the board has the right balance of skills for the future.** If not, the chairman should seek the resignation of under-performing directors and make new appointments to the board. **I therefore propose that the Code provides that the performance of the board as a whole, of its committees and of its members, is evaluated at least once a year (suggested Code provision A.6.1). It should be stated in the annual report whether such performance evaluation is taking place and how it is conducted (suggested Code provision A.6.2).**
- 11.23 Sometimes it can become clear either to the board and its chairman or to the director concerned that a new appointment is not working. In these circumstances an early “blame-free” resignation is preferable to continuing an unsatisfactory role.
- 11.24 The chairman has a key role in arranging the evaluation process for the board and for individual non-executive directors. Conduct of the evaluation by an external third party can bring objectivity to the process and its value should be recognised by chairmen. It is the chairman’s own performance is reviewed, an external third party or the senior independent director should act as facilitator. While the results of board evaluation as a whole should be shared with the board, the results of individual assessments should remain confidential between the chairman and the non-executive director concerned. The process of performance evaluation is evolving; suggested guidelines for carrying out performance appraisal, for both the board as a whole and for non-executive directors individually, are set out in Annex J for companies to tailor to meet their own needs.

## Information and the Company Secretary

- 11.25 In order for a non-executive director to be effective, adequate information of the right kind is vital. Information must be provided sufficiently in advance of meetings to enable non-executive directors to give issues thorough consideration and must be relevant, significant and clear. Some who responded to consultation stressed the dangers of data-overload, which could lead to important issues being overlooked. This was confirmed by my telephone survey where 21 per cent of the FTSE 100 non-executive directors interviewed said that they receive too much information.
- 11.26 Where a board is working effectively there will be a culture of openness. Non-executive directors’ contributions will be valued and trusted and the manipulation of information should not be an issue. The emphasis in all information flows should be on clarity and transparency. **The chairman, supported by the company secretary, should assess what information is required. The executive directors should assemble it and be ready to validate its accuracy, reliability and compliance with laws and standards (suggested Code provision A.2.5).**

- 11.27 **Good non-executive directors will also satisfy themselves that they have appropriate information of sufficient quality to make sound judgements. Non-executive directors should not hesitate in seeking clarification or amplification where necessary** (Code provision A.5.1).
- 11.28 It is also important that non-executive directors give constructive feedback on the value of material provided and guidance on what is required. Where information is not appropriate this should be clearly signalled through the chairman. It should be part of the annual evaluation of the board's performance to examine whether the information provided to the board meets directors' expectations and requirements.
- 11.29 The role of the company secretary is important in the provision of information and more widely in supporting the effective performance of non-executive directors. The value of a good company secretary was a recurring theme amongst consultees. Ultimately the value of a company secretary's contribution will be determined by the calibre of the individual concerned. At their best, as a provider of independent impartial guidance and advice, a good company secretary is uniquely well placed to assist a non-executive director and to support the chairman in ensuring good use is made of the non-executive directors.
- 11.30 The company secretary has a wide range of responsibilities but among those most central to enhancing non-executive director performance are the facilitation of good information flows, provision of impartial information and guidance on board procedures, legal requirements and corporate governance, together with best practice developments. They can also play a key part in facilitating induction and professional development for board members. **To ensure good communication within the board and its committees, it is good practice for the company secretary, or their designee, to be secretary to all board committees.**
- 11.31 The effectiveness of the company secretary will hinge on the nature of their working relationship with the chairman. **The company secretary should be accountable to the board through the chairman on all governance matters** (suggested Code provision A.5.2). Though there may be certain matters on which the company secretary reports to the chief executive, this should not undermine their overall responsibility to the board on all matters of corporate governance.
- 11.32 It is crucial to safeguard the integrity of the position, so that their impartiality is not compromised. All the board also need a clear understanding of the role of the company secretary.
- 11.33 In some companies, particularly smaller ones, the roles of company secretary and finance director are combined. Around 40 per cent of companies outside FTSE 350 combine the roles. There are obvious tensions in this in the context of impartiality and information provision. It is therefore desirable for larger companies, who are able, to separate the roles and for smaller companies

with limited resources to recognise the potential for conflict of interest and to build “Chinese walls” between the roles, by ensuring that information received in one capacity is not used for other purposes.

- 11.34 At present company law makes appointment of the company secretary a matter for the board. The Code, on the other hand, identifies the removal of the company secretary as a board matter. **I recommend, for clarity, that both appointment and removal of the company secretary are a matter for the board and that this is set out in the Code** (suggested Code provision A.5.5).



# TERMS OF ENGAGEMENT

## Tenure

- 12.1 A board should regularly re-evaluate the mix of skills and experience it needs and be able and willing to change its membership in an orderly manner over time. According to my research, the current population of non-executive directors have been in their roles to date for an average of 4.6 years. This suggests that on average a non-executive director spends significantly longer in a post.
- 12.2 Some submissions argued that there is a lengthy learning curve for a non-executive director, and that a long tenure is in the company's interests. I believe it is desirable to do everything possible to enable the non-executive director to accelerate this learning curve, by systematic and thorough due diligence and induction processes, followed up by training and professional development as necessary.
- 12.3 A balance has to be struck on tenure between all these factors. I do not favour an initial appointment for a non-executive director of less than three years (subject to satisfactory performance) and it is reasonable to expect most non-executive directors also to serve a second term of three years. Beyond six years the possible benefits of a fresh appointee need more careful consideration, although there will be cases where the particular director continues to justify their place on the board over a full nine year period.
- 12.4 It was put to me that non-executive directors should face annual re-election on the basis that under-performers can more readily be removed. However, I accept the argument that in the UK, where shareholders can vote against the re-election of a director and can call a special general meeting to remove a board, annual re-election of all directors could be potentially damaging to a company. It might encourage short-termism or leave a vacuum at the top of a company if an entire board is voted out in a protest by a minority of shareholders.
- 12.5 **I consider therefore that a non-executive director should normally be expected to serve two three-year terms with a company. There will be occasions where value will be added by a non-executive director serving for longer, but I would expect this to be the exception and the reasons for it explained to shareholders** (suggested Code provision A.7.3).
- 12.6 **I consider that after nine years annual re-election is appropriate for non-executive directors** (suggested Code provision A.7.3).
- 12.7 Taken together, these recommendations should encourage planned and progressive refreshing of listed company boardrooms.

- 12.8 As part of my research I found that the current population of chairmen of UK listed companies have on average been on the board for about seven years. There is certainly value in continuity and stability in the chairman's role. I do not believe that a standard term for tenure of chairmen is appropriate.
- 12.9 **However, it is useful to appoint the chairman for three-year terms which may be renewed where appropriate.** As part of its role in succession planning, the nomination committee should review the chairman's position and should take account of the advantage of continuity set against the desirability of a freshness of approach. For their part, chairmen should be sensitive to the need to make way for a successor when this would be in the interests of the company.

## Time commitment

- 12.10 This Review sets out the high standards expected of non-executive directors. To meet these standards and be effective, it is essential that non-executive directors commit the necessary time to the role. Other parts of the Review identify a need to ensure that non-executive directors devote time to induction, professional development, developing a strong base of knowledge of the company's affairs, participating in succession planning and greater involvement in discussions with shareholders.
- 12.11 Although there are wider extremes, research suggests that a non-executive director role usually involves a time commitment of between 15 and 30 days a year. Practice varies on whether the time commitment is articulated and agreed between the non-executive director and the board. The time involvement of a chairman varies much more widely. Both for the chairman and non-executive directors it is important that they are available at short notice to deal with major issues when they arise. At such times, a non-executive director, and particularly a chairman, may need to commit substantially more time.
- 12.12 The responses to my consultation showed that there was widespread concern about non-executive directors devoting insufficient time to what is an increasingly demanding role. This was also the most commonly expressed barrier to greater effectiveness of non-executive directors cited in the telephone survey (25 per cent).
- 12.13 There is value, therefore, in clarity of the expected time commitment of non-executive directors and chairmen. **I propose that the nomination committee should articulate the time and responsibility (including in relation to chairmanship, as the senior independent director, or membership of board committees) envisaged in the appointment of a non-executive director** (suggested Code provision A.4.4). **The non-executive director should undertake that they will have available sufficient time to meet what is expected of them, taking into account their other commitments. These commitments should be disclosed to the company before appointment, with an indication of the time involved** (suggested Code

provision A.4.6). In this way, a proper judgement can be made of whether the director is likely to have enough time for the role and would have sufficient flexibility to devote additional time where this was needed. Shareholders would be expected not to support the election (or re-election) of non-executive directors who are not in a position to commit appropriate time to their role.

**12.14 The nomination committee should annually review the time required and performance evaluation should be used to assess whether the non-executive director is spending enough time to fulfil their duties. If the non-executive director is offered appointments elsewhere, the chairman should be informed before any new appointment is accepted and the board should subsequently be informed (suggested Code provision A.4.7).**

12.15 The popular perception is that there are a large number of people holding multiple non-executive directorships and a number of submissions suggested that the number of such posts be subject to a limit. I found that less than one-fifth of non-executive directors hold more than one non-executive directorship in a UK listed company. 13 individuals hold five or more such posts. One in 14 non-executive directors also hold an executive director post. However many non-executive directors may also hold appointments in unlisted or non-UK companies as well as charitable, public sector or other roles.

12.16 The variety of different appointments and individual circumstances means that it is arbitrary and unrealistic to set a prescriptive limit for the number of non-executive directorships any individual not in full time employment may hold, and I do not propose one.

12.17 I consider, however, that the position as regards executive directors and chairmen of major companies is, as a matter of principle, different. There is undoubtedly value in executive directors participating on other boards of non-competing companies as non-executive directors. But shareholders have every reason to expect executive directors of the companies they own to focus effectively all their full time energies on the company which employs them. I propose that there should be a limit on the number of external roles in major companies which executive directors assume.

12.18 The role of the chairman is distinct from that of the non-executive director. In major companies it will be close to a full time engagement. The chairman, moreover, has the ultimate responsibility for the conduct of the board.

12.19 I believe therefore that best practice should be that:

- a full time executive director should not take on more than one non-executive directorship, nor become chairman, of a major company, and
- no individual should chair the board of more than one major company (suggested Code provision A.4.8).

I define a major company in this context as one included, or likely to be included shortly, in the FTSE 100.

## Remuneration

- 12.20 Research showed that the average remuneration of FTSE 100 non-executive directors is £44,000 p.a. Average remuneration for a non-executive director of a company outside the FTSE 350 is £23,000 p.a. For chairmen it is £426,000 p.a. and £78,000 p.a. respectively.
- 12.21 Views I received in response to consultation generally argued that the risk-reward balance was becoming less favourable and that in principle non-executive directors should be paid more, particularly as the time envisaged for the role is increasing.
- 12.22 In the telephone survey, ten per cent of chairmen and six per cent of non-executive directors cited insufficient pay as a barrier to greater non-executive effectiveness. This is much lower than barriers such as time, which 22 per cent of non-executive directors cited. It was not however generally argued that pay was a significant constraint on attracting high quality people to be non-executive directors, with the exception of those directors based in the US, where pay is considerably higher. Other views expressed were that if pay was significantly increased, or if the non-executive director was dependent on the pay from a particular company, their independence of mind could be prejudiced.
- 12.23 A parallel survey of board remuneration<sup>3</sup> showed that a majority felt that non-executive directors' pay was too low. However, when asked to quantify what the level of pay should be, an annual rate of between £40,000 and £60,000 for FTSE 100 (compared to £44,000 in practice) and between £25,000 and £40,000 (compared to £23,000 now) for smaller listed companies was suggested. This suggests that pay is not in practice significantly out of line with expectations for larger companies, but may possibly be out of line with expectations for smaller listed companies.
- 12.24 Remuneration for directors needs to be sufficient to attract and retain high calibre candidates but no more than is necessary for this purpose. **The level of remuneration appropriate for any particular non-executive director role should reflect the likely workload, the scale and complexity of the business and the responsibility involved.** In practice, it may be helpful in assessing remuneration for non-executive directors to use as a benchmark the daily remuneration of a senior representative of the company's professional advisers. The risk of high levels of remuneration (or a large shareholding) prejudicing independence of thought is real and should be avoided. Where a non-executive director has extra responsibilities (such as membership or chairmanship of board committees), the total remuneration should reflect these. I recommend that **non-executive directors' fees should be more clearly built up from an annual fee, meeting attendance fees (to include board committee meetings) and an additional fee for the chairmanship of committees (typically a multiple of the attendance fee) or role as**

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<sup>3</sup> Institute of Directors' survey, September 2002.

**senior independent director.** The level of remuneration for non-executive directors should be a matter for the chairman and the executive directors of the board.

- 12.25 In addition, companies should expect to pay additional, reasonable expenses in addition to the director's fee to cover related costs incurred by their non-executive directors (such as travel and administrative costs). Any significant support of this kind should be agreed in advance.
- 12.26 Some responses to consultation opposed the holding of shares by non-executive directors. The more general view was that shares could be helpful in aligning the interests of the director with the long-term interests of shareholders. It is undesirable, however, for any shareholdings to represent a large proportion of the individual non-executive director's financial wealth. **I conclude that there is merit in the current practice of some companies giving their non-executive directors the opportunity to take part of their remuneration in the form of shares in lieu of cash.**
- 12.27 Most responses to consultation opposed the use of options in non-executive director remuneration because of the risk of undesirable focus on share price rather than underlying company performance. Similarly, participation by non-executive directors in incentive or pension schemes was felt to be undesirable. **I conclude that non-executive directors should not hold options over the shares of their company** (suggested Code provision B.1.7). **If, exceptionally some payment is made by means of options, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until one year after the non-executive director leaves the board.**
- 12.28 I recommend in Chapter 10 that it would be desirable for companies to encourage executive directors and senior executives to take on non-executive posts elsewhere. **Where companies release an executive director to serve as a non-executive director elsewhere, they should include in their remuneration policy reports whether or not the director will retain such earnings and, if so, what the remuneration is.**
- 12.29 The Company Law Review recommended (as originally suggested by the Law Commission) that non-executive director terms of engagement (both contracts and ancillary provisions) should be disclosed. **It is important that these should be publicly available. I consider that the Code should be clarified to require this** (suggested Code provision A.4.11).
- 12.30 As regards remuneration of chairmen, concern was expressed in consultation about the shortage of supply of able candidates for the role of chairman. This was not, however, attributed to levels of pay, which already reflect the considerable commitment and time required for the role. There is, nonetheless, scope for the remuneration of chairmen to be more imaginatively structured to provide a greater degree of alignment with shareholders' interests than would be appropriate for non-executive directors.

## Resignation

- 12.31 Some of those who responded to the consultation described the resignation of a non-executive director as being the ultimate sanction at their disposal. I believe that resignation should be regarded very much as a last resort once other efforts to resolve problems have failed. Indeed, non-executive directors may be constrained from resigning by their fiduciary duty to act in the company's best interests. **Where non-executive directors have real concerns about the way in which a company is being run or about a course of action proposed by the board, the first step should be to raise their concerns with the chairman and their fellow directors. Non-executive directors should, as a matter of course, ensure that their concerns are recorded in the minutes of the board meeting if they cannot be resolved.**
- 12.32 **If the non-executive director feels that resignation is the only course of action left, a written statement should be provided to the chairman, for circulation to the board, setting out the reasons for resignation. I would also recommend that a non-executive director should explain their reasons for resigning when they leave in other circumstances** (suggested Code provision A.1.6). While I would not anticipate the chairman usually making such a statement publicly available, although there may be circumstances when they would wish to do so, I would expect shareholders to make their own enquiries into the reasons for resignation of directors when they are not apparent.

# AUDIT AND REMUNERATION COMMITTEES

- 13.1 The increased use of board committees on audit, remuneration and nomination has played an important role in raising standards of corporate governance. Although the board retains ultimate responsibility, these committees give assurance that important board duties are being rigorously discharged. The Code provides that non-executive directors, and in particular independent non-executive directors, should play a leading role in these committees to avoid conflicts of interest for executive directors.
- 13.2 When appointing committee members, boards should draw on the independent non-executive directors with the most relevant skills and experience. Consideration should also be given to rotating committee members. In order not to concentrate too much influence on one individual, **I consider it undesirable for any one individual to be on all three principal board committees at the same time** (suggested Code provision A.3.7).
- 13.3 The nomination committee was discussed in Chapter 10.

## Audit committee

- 13.4 In the wake of a number of high profile corporate collapses in the US, the audit committee has become the subject of close scrutiny in both the US and the UK.
- 13.5 As noted earlier, in February 2002, alongside this Review, the Secretary of State for Trade and Industry and the Chancellor set up the CGAA to consider wider issues of accountancy and audit reform. The Group produced an interim report in July. It recommended that the role and membership of audit committees should be strengthened and that the audit committee should approve the purchase of non-audit services and should have the principal responsibility for making recommendations on auditor appointment to shareholders. In her July statement to the House of Commons on the interim report, the Secretary of State for Trade and Industry called for audit committees to consist exclusively of independent non-executive directors.
- 13.6 The interim report of the CGAA also proposed the creation of a separate group, under the auspices of the FRC, to develop existing Code guidance for audit committees. The group, chaired by Sir Robert Smith, today published detailed recommendations on audit committees.
- 13.7 **I welcome Sir Robert Smith's recommendations and I believe that they will assist audit committees in increasing their effectiveness.** Where the group makes recommendations for the Code, these have been incorporated into the proposed new draft Code at Annex A.

## **SUMMARY OF RECOMMENDATIONS BY SIR ROBERT SMITH'S GROUP**

### **Composition of the audit committee**

- Committee to include at least three members, all independent non-executive directors.
- At least one member to have significant, recent and relevant financial experience.

### **Role of the audit committee**

- To monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgements;
- To review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems;
- To monitor and review the effectiveness of the company's internal audit function;
- To make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- To monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant UK professional and regulatory requirements; and
- To develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm.

### **Resources**

- The committee to be provided with sufficient resources to undertake its duties.

### **Reporting to shareholders**

- The directors' report to contain a separate section that describes the role of the committee and what action it has taken.
- The chairman of the audit committee to be present at the AGM to answer questions, through the chairman of the board.

### **Code provisions and related guidance**

- The recommendations above to be reflected in the revised Code (suggested Code provisions D.2.2 and D.3.1 to D.3.5) and amplified in detailed guidance.

The full report is available at [www.frc.org.uk/publications](http://www.frc.org.uk/publications).



## Remuneration committee

- 13.8 The Code provides that a board should have a remuneration committee consisting exclusively of non-executive directors who are independent of management. Most listed companies have a separate remuneration committee. All except two in the FTSE 350 do, as do 85 per cent of companies outside the FTSE 350. The independence of members of the remuneration committee from executive management is necessary in view of the potential for conflicts of interest. This is not to say, however, that the chairman and chief executive may not attend committee meetings when invited to do so. Indeed, I would expect the committee to wish to know their views.
- 13.9 Judgements on remuneration require sensitivity not just to the expectations of executive directors but also to the perceptions and concerns of investors and wider constituencies. Research confirmed the worries of many directors that compensation consultants were often perceived to be too close to executive management and too ready to encourage companies to position their remuneration policy in the “upper quartile” of their peer group comparators. Such a policy can have a one way ratchet effect which is undesirable for individual companies and inflationary and self-defeating in the market place.
- 13.10 **The remuneration committee needs to work closely with the nomination committee to ensure that incentives are appropriately structured for directors and for senior executives and that terms in the event of severance are carefully considered. The broad aim should be to avoid rewarding poor performance while dealing fairly with cases where departure is not due to poor performance (suggested Code provision B.1.10).**
- 13.11 **I recommend that the Code should provide that all members of the remuneration committee should meet the test of independence. The committee should have at least three members. It should have published terms of reference which set out its delegated responsibilities (suggested Code provisions B.2.1 and B.2.2). A summary of the principal duties of the remuneration committee is provided in Annex E.**
- 13.12 **At a minimum, the committee should have delegated responsibility for setting remuneration for all executive directors and the chairman. The committee should also set the level and structure of compensation for senior executives. The committee should be responsible for appointing remuneration consultants. If executive directors or senior management support the remuneration committee, this role should be clearly separated from their executive role within the business (suggested Code provision B.2.2). The frequency of and attendance of members at remuneration committee meetings should be disclosed in the annual report (suggested Code provision A.1.2).**



# LIABILITY OF NON-EXECUTIVE DIRECTORS

- 14.1 A concern often put to me during the course of the Review was about the potential liability attaching to non-executive director roles. This was particularly so in the light of the Equitable Life case. Some argued that consideration should be given to proportional liability and capping liability by way of contract, or to some form of business judgment defence. There was, however, also very strong support for the concept of the unitary board and for the legal duties of executive and non-executive directors to be the same. Moreover, some were concerned that if liability were reduced, non-executive directors would not take their responsibilities so seriously and this could undermine the unitary board.
- 14.2 At a time when the perceived risks associated with being a non-executive director are growing, the cost of directors' and officers' insurance is increasing and the coverage appears to be becoming less comprehensive. However, simply encouraging greater provision of insurance, while it might reduce the personal exposure of directors, would not remove reputational risk and paradoxically it would mean that there would be more to gain financially in taking action against directors. Directors may also not be covered to the full extent of their potential liability. They also may need to meet their own legal expenses.
- 14.3 It would not appear that concerns about potential liability are yet having a significant effect in deterring people from putting themselves forward at least in larger companies, but there must be a risk that such perceptions could reduce the willingness of able people to take on non-executive director roles.

## Liability

- 14.4 In a range of legislation (such as health and safety, environmental law, competition, as well as companies and insolvency legislation) obligations are imposed on the directors of a company as well as (or instead of) on the company itself. Some of these carry criminal sanctions, others may give rise to civil remedies in the hands of private third parties, insolvency practitioners or regulators.
- 14.5 General duties owed by directors to their company, which set standards of propriety of conduct and of skill and care, have been established over time through case law. These duties are owed to the company. This means that only the company (or a member by means of a derivative action on the company's behalf) can take action for breach. Scope for speculative shareholder litigation of the kind common in the US is extremely limited because of differences in both law and the procedure for bringing claims.

- 14.6 The remedy for breach of the duty of skill and care is damages. A director will not be liable unless the company can show that the director is in breach of the duty and that loss resulted. Currently it is possible for a director to ask for relief from liability under section 727 of the Companies Act 1985 if it appears to the Court that the director acted honestly and reasonably and that in all the circumstances ought fairly to be excused. Although the law does not apply different duties to executive and non-executive directors, it has been recognised that the knowledge, skill and experience expected will vary between directors with different roles and responsibilities (for example between the finance director or the sales director and a non-executive director).
- 14.7 An important problem faced by directors, particularly non-executive directors, has been that of knowing with certainty the extent of these duties. If the proposals of the Company Law Review to set out a statement of duties in statute are adopted, this uncertainty should be considerably reduced. Alongside the duties, it is, I understand, intended that guidance will be provided by the Government for the benefit of directors, which should also help.
- 14.8 **I suggest that in addition to that general guidance, some further guidance should be provided, by way of provision in the Code. I would expect that the Courts would wish to pay regard to such provision where it might be relevant to the case (for example in the context of determining what would be reasonably expected of a director in the defendant's position).**
- 14.9 The provisions I suggest are set out in the proposed new schedule to the Code at Annex A. The statement builds on directors' duties in relation to care, skill and diligence, by making clear that although non-executive directors and executive directors have the same legal duties and objectives as board members, their involvement is likely to be different. In particular, the time devoted to the company's affairs is likely to be significantly less for a non-executive director than for an executive director and the detailed knowledge and experience of a company's affairs that could reasonably be expected of a non-executive director will also in most cases be less than for an executive director.
- 14.10 The statement also reflects the recommendations I make elsewhere in the Review on non-executive directors ensuring that they have adequate knowledge and raise concerns appropriately, and on management providing sufficient, timely and accurate information.
- 14.11 Improved Court procedures and active case management are also very important. The long drawn out nature of proceedings is very detrimental reputationally as well as financially. This can be of particular importance, for example, where a director is applying for relief under section 727 of the Act. This is an important power for the Court and if such applications could be dealt with promptly it would give considerable reassurance to directors. **I recommend that the Lord Chancellor's Department consider steps to promote active case management in cases applying to directors.**

14.12 The Company Law Review looked at the question of the setting of sanctions which might apply to directors and set out some key principles in Annex D of its final report which should be applied when new legislation is being introduced. **I consider that it would be useful if, when criminal sanctions in relation to directors are being considered by Government, these principles are taken into account.**

14.13 I am also aware that the Law Commission recently reviewed limitation periods (which prevent claims in relation to events more than a certain time ago) and that the rules may be clarified. The benefits of reducing uncertainty about potential litigation for non-executive directors should be taken into account in this.

## Insurance and indemnification

14.14 Company law (section 310 of 1985 Act) allows a company to insure its directors against actions by the company or by third parties. It also allows a company to indemnify a director in respect of third party claims where the director is not in breach of duty or obligation to the company, but a commitment in advance to indemnify against legal costs is invalid unless contingent on a successful defence.

14.15 The Company Law Review recommended (in paragraph 6.3 of the Final Report) that companies should be able to indemnify in advance against the cost of defending proceedings, or of a section 727 relief application, provided that the decision was made by the disinterested members of the board on the basis of appropriate legal advice that the prospects of success were good, and that if the outcome was adverse the director would be bound to reimburse the company. It also recommended that it should be lawful for the company to indemnify a director against a *bona fide* excess of loss requirement on a liability insurance policy, under which the director is bound to pay the first tranche of any liability.

14.16 I support these recommendations. **I also suggest that the Government should go further, and provide that a company should be able to indemnify a director in advance against the reasonable cost of defending proceedings from the company itself, without trying to establish in advance the prospects of success of the case. The director would be bound to repay the costs if they lost.**

14.17 I recognise that the defendant director's ability to defend themselves would be dependent on the plaintiff's money and the company would in effect be paying the director's defence costs in a situation where the company would have decided that it was in its best interests to bring the proceedings. Although the director would be bound to repay the costs if they lost, there might be difficulty in recovering such money in practice. Nonetheless I consider that this proposal would be justified, taking account of the importance of ensuring that directors can rely on being defended with legal support comparable to that available to the company itself, and the wider aspects of safeguarding the pool of non-executive directors from being narrowed because of concerns about potential legal action.

- 14.18 As regards insurance cover, this is normally purchased by the company, although it can on occasion be purchased by individual directors. There is usually differentiation between executive and non-executive directors, but policies cover all directors and any subsidiary directors worldwide.
- 14.19 I consider that insurance is a basic protection for non-executive directors against suits by third parties. The benefit for companies is that it avoids the need to indemnify directors against such suits. **The Code should make reference to the need to provide appropriate directors' and officers' insurance** (suggested Code provision A.1.7). **I consider that companies should also supply details of their insurance cover to potential non-executive directors before they are appointed. If and when the law is changed, I consider that companies should also indemnify directors against any excess of loss requirement.**
- 14.20 It would appear that guidance for companies could be useful on what insurance should be provided for directors. **I am pleased that the City of London Law Society and ICSA, together with the ABI and BIBA, have agreed to draw up such guidance. This could include the risks that should be covered and those that cannot be, together with illustrative specimen policy terms. The guidance could also set out relevant factors that need to be considered, such as aggregate limits and exposure to potential actions outside the UK and the definition of what is a "wrongful act". Companies could then use this guidance as an aid in obtaining appropriate directors' and officers' insurance.**

## RELATIONSHIPS WITH SHAREHOLDERS

- 15.1 The role of the non-executive director includes an important and inescapable relationship with shareholders.
- 15.2 The structure of the UK equity market is diverse and has changed significantly over the last thirty years. Individual share ownership has fallen from over 50 per cent of the market in the 1960s to less than one fifth today. Meanwhile the UK market has become increasingly international, with overseas investors owning 30 per cent of the market, compared to below ten per cent three decades ago<sup>4</sup>.
- 15.3 The most significant change has, however, been the institutionalisation of the market. Occupational pension funds, insurance companies, pooled investment vehicles (for example unit and investment trusts) and other financial institutions such as charities, endowments and educational institutions, now hold more than half the equity capital of UK listed companies.
- 15.4 It is common practice for chief executives to have regular contacts with major shareholders. Chairmen often also participate. According to my telephone survey, three-quarters of chairmen discuss company business with some of their investors at least once a year. Through such meetings, these members of the board gain a clear insight into the views, and on occasion concerns, of the company's major shareholders. For their part, shareholders develop a better understanding of a wide range of issues from the point of view of management. These channels of communication are now widely accepted as both desirable and useful.
- 15.5 In contrast, only rarely do non-executive directors hear at first hand the views of major shareholders. The majority of non-executive directors (52 per cent) surveyed for the Review never discuss company business with their investors. Within the FTSE 100, contact is rarer still: only about one in five FTSE 100 non-executive directors discuss company business with investors once a year or more often.
- 15.6 Qualitative research undertaken for the Review showed that in normal circumstances non-executive directors and shareholders have only minimal direct contact. Interviews with investors revealed that rarely do they speak directly with non-executive directors, and only then where there is a serious problem. Even in these circumstances, discussion often centred on director remuneration rather than wider strategy or governance issues.

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<sup>4</sup> "Institutional Investment in the UK: A Review" by Paul Myners, April 2001.

- 15.7 Corroborating the evidence from the telephone survey, in-depth interviews revealed a widespread view amongst non-executive directors that investors are distant and disengaged. While expressing concern about the time commitment involved, small company non-executive directors tended to be sympathetic to the value of increased shareholder contact.
- 15.8 Executive directors, by contrast, were found to have reservations about more direct contact between non-executive directors and shareholders on the grounds that non-executive directors would not have enough detail available to them to present an accurate picture of company performance.
- 15.9 Despite significant variations in practice, the overall view amongst submissions to the consultation was that relationships between non-executive directors and shareholders could and should be closer.
- 15.10 Best practice as set out in the Code envisages the AGM as the forum for contact to take place between smaller shareholders and the board. This is important and I believe that, as the current Code provides, **non-executive directors, and in particular the chairmen of committees, should attend the AGM and be prepared to discuss issues that are raised in relation to their role** (suggested Code provision C.2.3).
- 15.11 I do not however accept the argument made in some submissions that the AGM should be the main or indeed only mechanism through which major shareholders and non-executive directors have direct contact.
- 15.12 One approach to strengthening relationships which has been mooted is for non-executive directors to meet with some of the company's major shareholders, individually or collectively, on a regular formalised basis without executive management present. The purpose of the meeting would not be for non-executive directors to communicate the company's strategy or to account for its performance. Non-executive directors would attend such meetings to listen to investors' views and to answer questions about governance. There has, however, been resistance to the format proposed on the basis that such meetings could be unduly time consuming for non-executive directors, might not be taken seriously by investors and could cause unhelpful tension between executive and non-executive directors. I understand and share these concerns.
- 15.13 Nevertheless, there is much merit in the principle that non-executive directors should hear directly the views of their major investors. A number of submissions – the Institute of Directors (IOD), ABI and the National Association of Pension Funds (NAPF) amongst them – suggested that a preferable approach would be for non-executive directors to attend some of the regular meetings that executive directors and the chairman have with key shareholders.
- 15.14 The chairman, as part of their role in ensuring effective communication with shareholders, needs to keep the board informed of major concerns raised by shareholders.



- 15.15 In addition, I propose that the senior independent director should attend sufficient of the regular meetings of management with a range of major shareholders to develop a balanced understanding of the themes, issues and concerns of shareholders. The senior independent director should communicate these views to the non-executive directors and, as appropriate, to the board as a whole (suggested Code provision C.1.2).
- 15.16 Boards should recognise that non-executive directors may also find it instructive to attend meetings with major investors from time to time and should be able to do so if they choose. Moreover, non-executive directors should expect to attend such meetings if requested by major investors in the company. They should, however, rely on the chairman and the senior independent director to ensure a balanced view is taken of the range of shareholder views (suggested Code provision C.1.2).
- 15.17 In addition, there are in practice a number of ways in which non-executive directors can inform themselves about the views of investors. Many companies undertake formal, regular investor relations surveys through their advisers or specialist intermediaries. Non-executive directors should encourage this practice and the board as a whole should discuss the results. There is also value in non-executive directors joining formal presentations to analysts and others of interim and final results to listen to questioning of executive management. **On appointment, non-executive directors should meet major investors, as part of the induction process** (suggested Code provision C.1.3).
- 15.18 The Code does not currently identify non-executive directors as having particular responsibilities towards shareholders, only that companies should be ready to enter into a dialogue with shareholders, based on a mutual understanding of objectives. **I recommend that companies should state in the annual report what steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop a balanced understanding of the views of major investors** (suggested Code provision C.1.1).
- 15.19 Several investors have complained of difficulties in making contact with non-executive directors (given that a number have several appointments) and were keen to have better access to discuss issues in a timely manner. To address this, **the company secretary should act as a conduit for contacts from major shareholders to non-executive directors.**

## The role of institutional investors

- 15.20 Investors can, and I believe should, play their part in ensuring that non-executive directors play an effective role on boards by questioning them on corporate governance matters. Such matters would include the functioning of the board, evaluation of the board's performance and how its results have been acted upon, the composition and diversity of experience of the board and the rigour and transparency of the appointments process. Investors should, however, not expect non-executive directors to be the source of information on company performance.

- 15.21 It is of real concern that many non-executive directors are critical of institutional investors who are often regarded as being too passive in relation to the companies in which they invest. The Government is trying to promote a culture in which institutional investors can and do pursue their beneficiaries' interests.
- 15.22 A need for more active engagement by institutional shareholders with the companies in which they invest was a central theme of Paul Myners' review of institutional investment, published in April 2001. Myners expressed concern about the value lost to institutional investors through the reluctance of fund managers actively to engage with companies in which they have holdings, even where they have strong reservations about strategy, personnel or other potential causes of underperformance.
- 15.23 Responding to the Myners Review, the Government has consulted on possible legislation to oblige institutions to promote their beneficiaries' interests through increased activism. In November last year, the ISC published on behalf of the industry a set of principles setting out strengthened responsibilities of institutional investors and agents. The principles outline best practice on the part of institutional investors to promote their members' interests through more active engagement as shareholders. The new principles will be included in industry fund management contracts.
- 15.24 **I endorse the Government's approach to more active engagement by shareholders and hope that the financial community will make the ISC's code of activism work in practice. For completeness, I therefore propose that the ISC code of activism be endorsed through reference in section 2 of the Code (suggested Code provision E.2.1).**
- 15.25 **I also recommend that institutional investors should attend AGMs where practicable (suggested Code provision E.1.4).**

## SMALLER LISTED COMPANIES

### Smaller listed companies (outside FTSE 350)

- There are 1,847 listed companies outside the FTSE 350.
- The market capitalisation of these range from a few hundred thousand pounds to hundreds of millions of pounds.
- The average size of the board is six, with two non-executive directors, three executive directors and a chairman.
- Audit and recommendation committees are commonplace. (85 per cent of smaller listed companies have them.) However, less than a third (29 per cent) have a nomination committee.

- 16.1 In the Review I make recommendations for listed companies in the UK. In doing this, I am mindful that no one size fits all and in particular that listed companies vary significantly in size. I have separately examined what recommendations I should make for smaller listed companies.
- 16.2 Like Cadbury and Hampel, my starting point is that high standards of corporate governance are as important for smaller listed companies as for larger ones. All public companies, irrespective of size, have obligations to their owners.
- 16.3 The governance of smaller listed companies has improved over the last decade, but compliance with the Code is less for smaller companies.
- 16.4 Many of the directors of smaller companies we interviewed recognised the value non-executive directors bring. In addition to the role played in larger companies, mentoring the executive team was a benefit often cited of non-executive directors in smaller companies.
- 16.5 I recognise that it may be more challenging for smaller listed companies to comply with some of the Review's recommendations and I have given careful consideration to the concerns about the costs of compliance for smaller companies, as expressed in responses to the consultation document and in interviews with directors of smaller listed companies.
- 16.6 In particular I am conscious that smaller listed companies tend to have fewer non-executive directors, and a number of these may not be independent.
- 16.7 Many consultation responses were, however, keen for the principles that apply to larger listed companies to apply to smaller listed companies. In addition, none of the directors of smaller listed companies that we interviewed argued for different principles for smaller listed companies. The nature of the Code is such that companies can explain to shareholders where there is good reason for complying with the principles in a different way.

- 16.8 **I propose that the recommendation that no one individual should sit on all three committees should not apply to smaller listed companies** (suggested Code provision A.3.7). I do so acknowledging that even with half the board independent the overall size of the board of smaller listed companies may not make this feasible. **With this exception, I recommend that there should be no differentiation in the Code's provisions for larger and smaller companies. I recognise, however, that it may take more time for smaller listed companies to comply and that some of the Code's provisions may be less relevant or manageable for smaller companies.**
- 16.9 My recommendations are directed at listed companies, but I hope and expect that many of them will also be of relevance to non-listed companies.

## MAKING CHANGE HAPPEN

- 17.1 The success of this Review will rightly be judged by the extent to which behaviours and relationships are changed. Substantial change will not happen overnight. My hope is that through progressive strengthening of the existing framework, corporate accountability will increase and wealth creation will be enhanced.
- 17.2 The current comply or explain nature of the Code has worked well in practice and my proposals do not require a new approach.
- 17.3 Many of my recommendations propose textual changes to the Code. These I have consolidated into a draft new Code, attached as Annex A. **I hope that the FRC (responsible for overseeing the Code) and the FSA (responsible for the listing requirement that companies report on their compliance with the Code) will wish to take forward my proposals and that the resulting changes will be introduced as soon as practically possible, preferably for reporting years starting on or after 1 July 2003.**
- 17.4 Although I expect that a number of boards already comply with many of my recommendations, in practice some recommendations will inevitably be more challenging. For example, I anticipate that time will be needed by some companies before their boards have a majority of independent non-executive directors. I do not, however, consider that a longer transition period for these provisions should be written into the Code. Companies should explain whether they meet the Code's provisions and if not, why, including what steps they are taking to meet them.
- 17.5 I have also looked at other issues which do not require changes to the Code. These included certain recommendations to the Government, for example on liability and insurance of directors, and on training. I am also very pleased that the City of London Law Society and ICSA, together with the ABI and BIBA, have agreed to develop guidance on directors' and officers' insurance.
- 17.6 I am very pleased that a group of business leaders and others will be formed to take forward my recommendation that individuals from the non-commercial sector can bring highly relevant expertise to a PLC boardroom by describing the people of relevant skills and experience and identifying how to bring to greater prominence candidates who could make an effective contribution to the boards of listed companies. I hope that boards will use this work to broaden the diversity of experience in their boardroom.
- 17.7 I also hope, as described in the text of the Review, that chairmen encourage their executive directors and suitably qualified managers just below board level to take one non-executive director position on a non-competitor board.

- 17.8 Investors, and in particular large institutional investors, have much to gain from the improved corporate governance framework envisaged by the Review. I hope that they will actively engage with the companies in which they invest and press for delivery of the greater accountability that I envisage.
- 17.9 Increasing understanding of the role of the non-executive director and the behaviours that promote effective non-executive performance is an important objective of the Review. In addition to the proposed changes to the Code I provide, in Annexes C and D, best practice guidance for an effective non-executive director and chairman. These short summaries will, I hope, be of value to individuals and boards as a whole and I encourage company secretaries to make widespread use of them, in particular when new directors join the board.
- 17.10 The Annexes also include a sample letter of non-executive director appointment, guidance on pre-appointment due diligence that I recommend non-executive directors should undertake before accepting a post, guidance on performance evaluation, and summaries of the principal duties of the nomination and remuneration committees.

## Measuring change

- 17.11 **To determine the extent to which behaviour has changed as a result of my proposals, I would invite the Government and the FRC to review progress against the recommendations of this Review in two years' time.** Where behaviour has not evolved as I have envisaged, this subsequent work might explore the reasons why. This might involve some qualitative as well as quantitative assessment.
- 17.12 In particular, I envisage that later work might build on the data and information collected for this report, and the work of other institutions, by considering for example:
- the proportion of independent directors on boards, based on what I hope will become a universally accepted definition of independence;
  - the existence of board committees meeting the independence requirements;
  - the extent of separation of chief executive and chairman roles, and the proportion of chairmen who were independent at the time of appointment;
  - the extent of rigorous, fair and open appointments processes including the use of formal processes to identify candidates in the light of an evaluation of the skills, knowledge and experience on the board;
  - the diversity of skills and expertise on boards;
  - the provision and take-up of professional development opportunities by non-executive directors and chairmen;

- how best practice has developed on individual, board and committee performance evaluation;
- the length of tenure of non-executive directors and chairmen; and
- attendance of the senior independent director and as appropriate non-executive directors at management meetings with major shareholders.





# ANNEX A – SUGGESTED REVISED CODE (INCORPORATING REVIEW RECOMMENDATIONS)

## Part 1 Principles of Good Governance

### SECTION 1 COMPANIES

#### **A DIRECTORS**

##### *The Board*

1. Every listed company should be headed by an effective board. The board is collectively responsible for promoting the success of the company by directing and supervising the company's affairs.

##### *Chairman and Chief Executive*

2. There are two key tasks at the top of every public company – the running of the board and the executive responsibility for the running of the company's business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority such that no one individual has unfettered powers of decision.

##### *Board balance and independence*

3. The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision taking.

##### *Appointments to the Board*

4. There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.

##### *Information and professional development*

5. The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All new directors should receive induction on joining the board and should continually update and refresh their skills and knowledge.

##### *Performance evaluation*

6. Boards should evaluate their performance.

##### *Re-election*

7. All directors should be required to submit themselves for re-election at regular intervals and at least every three years subject to continued satisfactory performance.

## **B. REMUNERATION<sup>1</sup>**

### *The Level and Make-up of Remuneration*

1. Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully, but companies should avoid paying more than is necessary for this purpose. A proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

### *Procedure*

2. Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

### *Disclosure*

3. The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director.

## **C. RELATIONS WITH SHAREHOLDERS**

### *Dialogue with Shareholders*

1. Companies should enter into a dialogue with shareholders based on the mutual understanding of objectives.

### *Constructive Use of the AGM*

2. Boards should use the AGM to communicate with investors and encourage their participation.

## **D. ACCOUNTABILITY AND AUDIT**

### *Financial Reporting*

1. The board should present a balanced and understandable assessment of the company's position and prospects.

### *Internal Control*

2. The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

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<sup>1</sup> Some of the provisions on directors' remuneration have been superseded by the Directors' Remuneration Report Regulations 2002 S.I 2002/1986 and a revision of the Code will need to reflect this.

### *Audit Committee and Auditors*

3. The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

## *SECTION 2 INSTITUTIONAL SHAREHOLDERS*

### **E. INSTITUTIONAL INVESTORS**

#### *Shareholder Voting*

1. Institutional shareholders have a responsibility to make considered use of their votes.

#### *Dialogue with Companies*

2. Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.

#### *Evaluation of Governance Disclosures*

3. When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention.

## **Part 2 Code of Best Practice**

### *SECTION 1 COMPANIES*

#### **A. DIRECTORS**

##### A.1 *The Board*

#### *Principle*

**Every listed company should be headed by an effective board. The board is collectively responsible for promoting the success of the company by directing and supervising the company's affairs.**

#### *Code Provisions*

- A.1.1 The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are fully understood and met.

- A.1.2 The board should meet regularly and there should be a formal schedule of matters specifically reserved for its decision. The number of meetings of the board and of its main committees and individual attendance should be identified in the annual report.
- A.1.3 The board should publish a high level statement of which decisions are to be taken by the board and which are to be delegated to management.
- A.1.4 Non-executive directors should constructively challenge and contribute to the development of strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of executive remuneration and have a prime role in appointing, and where necessary removing, senior management and in succession planning.
- A.1.5 The non-executive directors should meet regularly as a group without the executives present and at least once a year without the chairman present. The meetings should be led by the senior independent director. There should be a statement in the annual report on whether the non-executive directors have met without the chairman or executives present.
- A.1.6 Where they have concerns about the way in which a company is being run or about a course of action being proposed by the board, directors should ensure that their concerns are recorded in the board minutes if they cannot be resolved. A written statement should be provided to the chairman, for circulation to the board, setting out the reasons where a non-executive director resigns.
- A.1.7 Companies should arrange appropriate insurance cover in respect of legal action against its directors.

## A.2 *Chairman and chief executive*

### *Principle*

**There are two key tasks at the top of every public company – the running of the board and the executive responsibility for the running of the company’s business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority such that no one individual has unfettered powers of decision.**

### *Code Provision*

- A.2.1 The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established. It should be set out in writing and agreed by the board.

- A.2.2 The chairman and the chief executive should be identified in the annual report.
- A.2.3 A chief executive should not go on to become chairman of the same company.
- A.2.4 On appointment, the chairman should meet the independence criteria set out in A.3.4 below.
- A.2.5 The chairman is responsible for leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda. The chairman is also responsible for ensuring that the directors receive accurate, timely and clear information. The chairman should ensure effective communication with shareholders. The chairman should also facilitate the effective contribution of non-executive directors and ensure constructive relations between executive and non-executive directors.

### A.3 *Board balance and independence*

#### *Principle*

**The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision taking.**

#### *Code Provisions*

- A.3.1 Boards should not be so large as to become unwieldy. The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business and that changes to the board's composition can be managed without undue disruption.
- A.3.2 To ensure that power and information are not concentrated in one or two individuals, there should also be a strong executive representation on the board.
- A.3.3 All directors must take decisions objectively in the interests of the company.
- A.3.4 A non-executive director is considered independent when the board determines that the director is independent in character and judgement, and there are no relationships or circumstances which could affect, or appear to affect, the director's judgement.

Such relationships or circumstances would include where the director:

- is a former employee of the company or group until five years after employment, or any other material connection, has ended;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;

- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than ten years.

The board should identify in its annual report the non-executive directors it determines to be independent. The board should state its reasons if a director is considered independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination.

- A.3.5 At least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent.
- A.3.6 A senior independent director should be identified in the annual report. He or she should be available to shareholders if they have reason for concern on which contact through the normal channels of chairman or chief executive is inappropriate or has failed to resolve.
- A.3.7 Unless the company is small, no individual should sit on all three principal board committees at the same time.

#### A.4 *Appointments to the Board*

##### *Principle*

**There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.**

##### *Code Provision*

- A.4.1 All listed companies should have a nomination committee which should lead the process for board appointments and make recommendations to the board. The nomination committee should consist of a majority of independent non-executive directors. It may include the chairman of the board, but should be chaired by an independent non-executive director. The chairman and members of the nomination committee should be identified in the annual report.
- A.4.2 The nomination committee should make publicly available terms of reference explaining its role and the authority delegated to it by the board.
- A.4.3 Before making an appointment, the nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.

- A.4.4 The nomination committee should set out in the letter of appointment the time and responsibility (including in relation to chairmanship or membership of board committees or as the senior independent director) envisaged in the appointment of a non-executive director.
- A.4.5 The board should set out to shareholders why they believe an individual should be appointed to a non-executive role and how they meet the requirements of the role.
- A.4.6 The non-executive director should undertake that they will have sufficient time to meet what is expected of them, taking into account their other commitments. These commitments should be disclosed to the company before appointment, with an indication of the time involved.
- A.4.7 The nomination committee should review annually the time required from a non-executive director and performance evaluation should be used to assess whether the non-executive director is spending enough time to fulfil their duties. If the non-executive director is offered appointments elsewhere, the chairman should be informed before any new appointments are accepted and the board should subsequently be informed.
- A.4.8 A full time executive director should not take on more than one non-executive directorship, nor become chairman, of a major (FTSE 100) company. No individual should chair the board of more than one such company.
- A.4.9 The nomination committee should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management to maintain an appropriate balance of skills on the board.
- A.4.10 The nomination committee should make a statement in the annual report detailing its activities and the process it has used to make appointments. An explanation should be given if external advice or open advertising has not been used.
- A.4.11 Terms and conditions of appointment of non-executive directors should be published.

A.5 *Information and professional development*

*Principle*

**The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All new directors should receive induction on joining the board and should continually update and refresh their skills and knowledge.**

*Code Provision*

- A.5.1 Information volunteered by management may not be enough in all circumstances and directors should make further enquiries where necessary.

- A.5.2 The company secretary should be accountable to the board through the chairman on all governance matters.
- A.5.3 There should be a procedure agreed by the board for directors in the furtherance of their duties to take independent professional advice at the company's expense.
- A.5.4 All directors should have access to the impartial advice and services of the company secretary who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Under the direction of the chairman the company secretary's responsibilities include facilitating induction and professional development, ensuring good information flows within the board, its committees and between non-executive directors and senior management.
- A.5.5 Both the appointment and the removal of the company secretary should be a matter for the board as a whole.
- A.5.6 It is the responsibility of the chairman to ensure that new directors receive comprehensive, formal and tailored induction on joining the board. This should include, amongst other things, meeting major investors.
- A.5.7 The chairman should ensure that the directors continually update the skills and knowledge required to fulfil their role both on the board and on board committees. The company should acknowledge that as part of the cost of running an effective board they need to provide money and time for developing and updating their directors.

A.6 *Performance evaluation*

*Principle*

**Boards should evaluate their performance.**

*Code Provision*

- A.6.1 Performance evaluation of the board, its committees and its individual directors should be undertaken at least once a year. The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, appointing new members to the board or seeking the resignation of directors.
- A.6.2 The board should state in the annual report whether such performance evaluation is taking place and how it is conducted.

A.7 *Re-election*

*Principle*

**All directors should be required to submit themselves for re-election at regular intervals and at least every three years subject to continued satisfactory performance.**



### *Code Provision*

- A.7.1 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Act provisions relating to the removal of a director, and reappointment should not be automatic.
- A.7.2 All directors should be subject to election by shareholders at the first opportunity after their appointment, and to re-election thereafter at intervals of no more than three years.
- A.7.3 Non-executive directors would normally be expected to serve two terms of three years subject to continued satisfactory performance, but may exceptionally serve longer where this would be in the interests of the company and the reasons are explained to shareholders. Non-executive directors serving nine years or more should be subject to annual re-election.
- A.7.4 Before proposing re-election, the chairman should confirm as a result of performance evaluation that they are satisfied that the non-executive director continues to contribute effectively and demonstrate commitment to the role.

## **B. REMUNERATION**

### B.1 *The Level and Make-up of Remuneration*

#### *Principle*

**Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully, but companies should avoid paying more than is necessary for this purpose. A proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.**

#### *Code Provisions*

##### **Remuneration policy**

- B.1.1 The remuneration committee should provide the packages needed to attract, retain and motivate executive directors of the quality required but should avoid paying more than is necessary for this purpose.
- B.1.2 Remuneration committees should judge where to position their company relative to other companies. They should be aware what comparable companies are paying and should take account of relative performance. But they should use such comparisons with caution, in view of the risk that they can result in an upward ratchet of remuneration levels with no corresponding improvement in performance.
- B.1.3 Remuneration committees should be sensitive to broader issues, including pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

- B.1.4 The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels.
- B.1.5 Executive share options should not be offered at a discount save as permitted by paragraphs 13.30 and 13.31 of the Listing Rules.
- B.1.6 In designing schemes of performance-related remuneration, remuneration committees should follow the provisions in Schedule A to this Code.
- B.1.7 Levels of remuneration for non-executive directors should reflect the time and responsibilities of the role. Remuneration for non-executive directors in share options should be avoided.

#### *Service Contracts and Compensation*

- B.1.8 Notice or contract periods should be set at one year or less.
- B.1.9 If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce after the initial period.
- B.1.10 Remuneration committees should consider what compensation commitments (including pension contributions) their directors' contracts of service, if any, would entail in the event of early termination. They should, in particular, consider the advantages of providing explicitly in the initial contract for such compensation commitments except in the case of removal for misconduct. In doing so, they should bear in mind the need to ensure that such provisions do not have the effect of rewarding poor performance which would not amount to misconduct or otherwise entitle the company to terminate the contract.
- B.1.11 Where the initial contract does not explicitly provide for compensation commitments, remuneration committees should, within legal constraints, tailor their approach in individual early termination cases to the wide variety of circumstances. The broad aim should be to avoid rewarding poor performance while dealing fairly with cases where departure is not due to poor performance and to take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.

#### B.2 *Procedure*

##### *Principle*

**Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.**

### *Code Provisions*

- B.2.1 The remuneration committee should consist exclusively of independent non-executive directors and should have at least three members.
- B.2.2 The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also set the level and structure of remuneration for senior executives. The remuneration committee should make publicly available its terms of reference, explaining its role and the authority delegated to it by the board.
- B.2.3 The members of the remuneration committee should be listed each year in the board's remuneration report to shareholders (B.3.1 below).
- B.2.4 The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors, including members of the remuneration committee, within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a small sub-committee, which might include the chief executive.
- B.2.5 The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing consultants in respect of executive director remuneration. If executive directors or senior management are involved in advising or supporting the remuneration committee, this role should be clearly separated from their role within the business.
- B.2.6 The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

### B.3 *Disclosure*

#### *Principle*

**The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director.**

#### *Code Provisions*

- B.3.1 The board should report to the shareholders each year on remuneration. The report should form part of, or be annexed to, the company's annual report and accounts. It should be the main vehicle through which the company reports to shareholders on directors' remuneration.
- B.3.2 The report should set out the company's policy on executive directors' remuneration. It should draw attention to factors specific to the company. It should also set out the company policy on non-executive directors remuneration.

- B.3.3 In preparing the remuneration report, the board should follow the provisions in Schedule B to this Code.
- B.3.4 Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) save in the circumstances permitted by paragraph 13.13A of the Listing Rules.
- B.3.5 The board's annual remuneration report to shareholders need not be a standard item of agenda for AGMs. But the board should consider each year whether the circumstances are such that the AGM should be invited to approve the policy set out in the report and should minute their conclusions.

## **C. RELATIONS WITH SHAREHOLDERS**

### *C.1 Dialogue with Institutional Shareholders*

#### *Principle*

**Companies should enter into a dialogue with major shareholders based on the mutual understanding of objectives.**

- C.1.1 Boards should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major investors.
- C.1.2 The senior independent director should attend sufficient regular meetings of management with a range of major shareholders to develop a balanced understanding of the themes, issues and concerns of shareholders. The senior independent director should communicate these views to the non-executive directors and, as appropriate, to the board as a whole. Non-executive directors should be able to attend regular meetings with major investors and should expect to attend them if requested by major shareholders.
- C.1.3 On appointment, non-executive directors should meet major investors, as part of the induction process.

### *C.2 Constructive Use of the AGM*

#### *Principle*

**Boards should use the AGM to communicate with investors and encourage their participation.**

#### *Code Provisions*

- C.2.1 Companies should count all proxy votes and, except where a poll is called, should indicate the level of proxies lodged on each resolution, and the balance for and against the resolution, after it has been dealt with on a show of hands.
- C.2.2 Companies should propose a separate resolution at the AGM on each substantially separate issue and should in particular propose a resolution at the AGM relating to the report and accounts.

C.2.3 The chairman of the board should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all non-executive directors to attend.

C.2.4 Companies should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting.

## **D. ACCOUNTABILITY AND AUDIT**

### *D.1 Financial Reporting*

#### *Principle*

**The board should present a balanced and understandable assessment of the company's position and prospects.**

#### *Code Provisions*

D.1.1 The directors should explain their responsibility for preparing the accounts and there should be a statement by the auditors about their reporting responsibilities.

D.1.2 The board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

D.1.3 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

### *D.2 Internal Control*

#### *Principle*

**The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.**

#### *Code Provisions*

D.2.1 The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.

D.2.2 Companies which do not have an internal audit function should every year review the need for one.

### *D.3 Audit Committee and Auditors*

#### *Principle*

**The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.**

- D.3.1 The board should establish an audit committee of at least three members, who should all be independent non-executive directors. At least one member of the audit committee should have significant, recent and relevant financial experience.
- D.3.2 The main role and responsibilities should be set out in written terms of reference and should include:
- to monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgements contained in them;
  - to review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems;
  - to monitor and review the effectiveness of the company's internal audit function;
  - to make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
  - to monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant UK professional and regulatory requirements;
  - to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm.
- D.3.3 The audit committee should be provided with sufficient resources to undertake its duties.
- D.3.4 The annual report should contain a separate section that describes the role and responsibilities of the committee and the actions taken by the committee to discharge those responsibilities.
- D.3.5 The chairman of the audit committee should be present at the AGM to answer questions, through the chairman of the board.

*These provisions are amplified in the 'Guidance on Audit Committees' to be attached to the Code. As the introduction to the guidance explains, compliance with the parts of the guidance printed in bold type should be regarded as essential for compliance with the Code.*

## SECTION 2 INSTITUTIONAL SHAREHOLDERS

### E. INSTITUTIONAL INVESTORS

#### E.1 *Shareholder Voting*

##### *Principle*

**Institutional shareholders have a responsibility to make considered use of their votes.**

##### *Code Provisions*

- E.1.1 Institutional shareholders should endeavour to eliminate unnecessary variations in criteria which each applies to the corporate governance arrangements and performance of the companies in which they invest.
- E.1.2 Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.
- E.1.3 Institutional shareholders should take steps to ensure their voting intentions are being translated into practice.
- E.1.4 Institutional investors should be expected to attend AGMs where practicable.

#### E.2 *Dialogue with companies*

##### *Principle*

**Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.**

- E.2.1 Institutional shareholders should apply the principles set out in the Institutional Shareholder's Committee's Code of activism which should be included in fund manager contracts.

#### E.3 *Evaluation of Governance Disclosures*

##### *Principle*

**When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention.**

## **NEW SCHEDULE TO BE ANNEXED TO CODE**

### *Guidance on liability of non-executive directors: care, skill and diligence*

Although non-executive directors and executive directors have the same legal duties and objectives as board members, the time devoted to the company's affairs is likely to be significantly less for a non-executive director than for an executive director and the detailed knowledge and experience of a company's affairs that could reasonably be expected of a non-executive director will generally be less than for an executive director. These matters may be relevant in assessing the knowledge, skill and experience which may reasonably be expected of a non-executive director and therefore the care, skill and diligence that they may be expected to exercise.

In this context, the following elements of the Code may also be particularly relevant.

In order to enable directors to fulfil their duties, the Code states that:

- the contract or letter of appointment of the director should set out what is expected of them including the level of responsibility and time commitment (suggested Code provision A.4.4); and
- the chairman should provide sufficient, accurate, timely and clear information to board members to give them a fair and balanced understanding of relevant issues (suggested Code provision A.2.5).

Non-executive directors should themselves:

- undertake appropriate induction and, as needed, professional development (suggested Code principle A.5);
- make appropriate enquiries, and where necessary, take and follow appropriate professional advice (suggested Code provision A.5.3);
- where they have concerns, ensure that these are addressed by the board and to the extent that they are not resolved, ensure that they are recorded (suggested Code provision A.1.6); and
- give a statement of reasons to the board if they resign (suggested Code provision A.1.6).

It is up to each non-executive director to reach a view as to what is necessary in particular circumstances to comply with the duty of care, skill and diligence they owe as a director to the company.

In considering whether or not a person is in breach of that duty, a court would take into account all relevant circumstances. These may include having regard to the above where relevant to the issue of liability of a non-executive director.



# ANNEX B – NON-CODE RECOMMENDATIONS

## *Role of the non-executive director*

- Prior to appointment, potential new non-executive directors should carry out their own due diligence on the board and on the company, and satisfy themselves that they have the knowledge, skills, experience and time to make a positive contribution to the board. Guidance on pre-appointment due diligence is offered (Annex G).

## *Recruitment and appointment*

- Chairmen and chief executives should consider implementing executive development programmes to train and develop suitable individuals in their companies for future director roles (paragraph 10.14).
- Boards should draw more actively from areas such as human resources, change management and customer care, where women tend to be more strongly represented, when making appointments, even if the appointees are not yet at board level (paragraph 10.25).
- Chairmen of listed companies should encourage and facilitate their executive directors and suitable senior management just below board level to take on one non-executive director position on a non-competitor board (paragraph 10.27).
- Companies operating in international markets could benefit from having at least one international non-executive director with relevant skills and experience on their board (paragraph 10.28).
- Lawyers, accountants and consultants can bring a set of skills that are useful to the board. Such organisations should allow suitable candidates to take on non-executive director roles (paragraph 10.29).
- Boards should look to private companies, some of which are of significant scale, as a source of non-executive directors (paragraph 10.30).
- There are individuals in charitable or public sector bodies who have developed strong commercial and market understanding. Including them on a PLC board can increase the breadth and diversity of experience that can in turn increase its effectiveness (paragraph 10.31).

- A group of business leaders and others will be set up to identify how to bring to greater prominence candidates for non-executive director appointment from the non-commercial sector (paragraph 10.32).
- Companies should consider bringing onto the boards of subsidiary companies talented individuals from wider and more diverse backgrounds to give them exposure to the operation of a board as a possible stepping-stone to the board of a listed company (paragraph 10.33).
- Three principles should be observed when a board is appointing a new chairman. The senior independent director or deputy chairman, if independent, should normally lead the appointment process. The incumbent chairman should not assume this role. Clearly, any individual who is putting themselves forward as a candidate should not be involved in the appointment process. Although the decision is ultimately for the board as a whole, the group leading the process, if not the nomination committee, should comprise a majority of independent non-executive directors. A systematic approach should be taken to identify the skills and expertise required for the role and a job specification prepared. A short-list of good candidates should be considered, rather than possible individuals being considered in turn. The process will almost certainly require external advice (paragraph 10.35).

### *Induction and professional development*

- Non-executive directors should regularly appraise their individual skills, knowledge and expertise, and determine whether further professional development would help them develop their expertise and fulfil their obligations as members of the existing board (paragraph 11.12).
- The chairman should address the developmental needs of the board as a whole with a view to enhancing its effectiveness as a team (paragraph 11.14).
- There should be a step change in training and development provision so that it is suited to the needs of boards (paragraph 11.17).
- The Review provides an induction checklist (Annex I).

### *Information and company secretary*

- The chairman, supported by the company secretary, should assess what information is required. The executive directors should assemble it and be ready to validate its accuracy, reliability and compliance with laws and standards (paragraph 11.26).
- Good non-executive directors will satisfy themselves that they have adequate information of sufficient quality to make sound judgements. Non-executive directors should not hesitate in seeking clarification or amplification where necessary (paragraph 11.27).

- To ensure good communication within the board and its committees, it is good practice for the company secretary, or their designee, to be secretary to all board committees (paragraph 11.30).

### *Terms of engagement*

- It is appropriate to appoint the chairman on a three-year term which may be renewed where appropriate (paragraph 12.9).
- Endorse the approach taken by some companies to give their non-executive directors the opportunity to take part of their remuneration in the form of shares in lieu of cash (paragraph 12.26).
- If, exceptionally, some payment is made by means of options, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until one year after the end of the appointment (paragraph 12.27).
- Where companies release their executive directors to serve as a non-executive director elsewhere, they should include in their remuneration policy reports whether or not the director will retain such earnings and, if so, what the remuneration is (paragraph 12.28).

### *Liability*

- The Review invites the Lord Chancellor's Department to consider steps to promote active case management in cases applying to directors (paragraph 14.11).
- The Government is recommended to consider the guidance set out in the Company Law Review in considering criminal sanctions in the new Companies Act (paragraph 14.12).
- A company should be able to indemnify a director in advance against the reasonable cost of defending proceedings from the company itself, without trying to establish in advance the prospects of success of the case (paragraph 14.16).
- Companies should supply details of their directors' and officers' insurance cover to potential non-executive directors before they are appointed. If and when the law is changed, companies should also indemnify directors against any excess of loss requirement (paragraph 14.19).
- The City of London Law Society and ICSA, together with ABI and BIBA, have agreed to draw up guidance on insurance for directors for companies to use in obtaining appropriate directors' and officers' insurance (paragraph 14.20).

### *Relationships with shareholders*

- The company secretary should act as a conduit for contacts from major shareholders to non-executive directors (paragraph 15.19).

### *Smaller companies*

- With the exception of the recommendation that no one individual should sit on all three main committees, there should be no differentiation in the Code's provisions between small and large listed companies. The Review recognises that it may take more time for smaller listed companies to comply and that some of the Code's provisions may be less relevant or manageable for smaller companies (paragraph 16.8).

### *Making change happen*

- To determine the extent to which behaviour has changed as a result of the my proposals, the Government and the FRC are invited to review in two years' time progress against the recommendations of this Review (paragraph 17.11).

# ANNEX C – GUIDANCE FOR NON-EXECUTIVE DIRECTORS

As members of the unitary board, all directors are required to:

- provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed;
- set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives, and review management performance; and
- set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

In addition to these requirements for all directors, the role of the non-executive director has the following key elements:

- **Strategy:** Non-executive directors should constructively challenge and contribute to the development of strategy.
- **Performance:** Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives, and monitor the reporting of performance.
- **Risk:** Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.
- **People:** Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning.

Non-executive directors should constantly seek to establish and maintain confidence in the conduct of the company. They should be independent in judgement and have an enquiring mind. To be effective, non-executive directors need to build a recognition by executives of their contribution in order to promote openness and trust.

To be effective, non-executive directors need to be well-informed about the company and the external environment in which it operates, with a strong command of issues relevant to the business. A non-executive director should insist on a comprehensive, formal and tailored induction. An effective induction need not be restricted to the boardroom, so consideration should be given to visiting sites and meeting senior and middle management. Once in post, an effective non-executive director should seek continually to develop and refresh their knowledge and skills to ensure that their contribution to the board remains informed and relevant.

Best practice dictates that an effective non-executive director will ensure that information is provided sufficiently in advance of meetings to enable thorough consideration of the issues facing the board. The non-executive director should insist that information is sufficient, accurate, clear and timely.

An element of the role of the non-executive director is to understand the views of major investors both directly and through the senior independent director.

*The effective non-executive director:*

- upholds the highest ethical standards of integrity and probity;
- supports executives in their leadership of the business while monitoring their conduct;
- questions intelligently, debates constructively, challenges rigorously and decides dispassionately;
- listens sensitively to the views of others, inside and outside the board;
- gains the trust and respect of other board members; and
- promotes the highest standards of corporate governance and seeks compliance with the provisions of the Code wherever possible.

## ANNEX D – GUIDANCE FOR THE CHAIRMAN

The chairman is pivotal in creating the conditions for overall board and individual director effectiveness, both inside and outside the boardroom. Specifically, it is the responsibility of the chairman to:

- run the board and set its agenda. The agenda should take full account of the issues and the concerns of all board members. Agendas should be forward looking and concentrate on strategic matters rather than formulaic approvals of proposals which can be the subject of appropriate delegated powers to management;
- ensure that the members of the board receive accurate, timely and clear information, in particular about the company's performance, to enable the board to take sound decisions, monitor effectively and provide advice to promote the success of the company;
- ensure effective communication with shareholders and ensure that the members of the board develop an understanding of the views of major investors;
- manage the board to ensure that sufficient time is allowed for discussion of complex or contentious issues, where appropriate arranging for informal meetings beforehand to enable thorough preparation for the board discussion. It is particularly important that non-executive directors have sufficient time to consider critical issues and are not faced with unrealistic deadlines for decision-making;
- take the lead in providing a properly constructed induction programme for new directors that is comprehensive, formal and tailored, facilitated by the company secretary;
- take the lead in identifying and meeting the development needs of individual directors, with the company secretary having a key role in facilitating provision. It is the responsibility of the chairman to address the development needs of the board as a whole with a view to enhancing the overall effectiveness as a team;
- ensure that the performance of individuals and of the board as a whole and its committees is evaluated at least once a year; and
- encourage active engagement by all the members of the board.

### *The effective chairman:*

- upholds the highest standards of integrity and probity;
- sets the agenda, style and tone of board discussions to promote effective decision-making and constructive debate;
- promotes effective relationships and open communication, both inside and outside the boardroom, between non-executive directors and the executive team;
- builds an effective and complementary board, initiating change and planning succession in board appointments, subject to board and shareholders' approval;
- promotes the highest standards of corporate governance and seeks compliance with the provisions of the Code wherever possible;
- ensures a clear structure for and the effective running of board committees;
- ensures effective implementation of board decisions;
- establishes a close relationship of trust with the chief executive, providing support and advice while respecting executive responsibility; and
- provides coherent leadership of the company, including representing the company and understanding the views of shareholders.



# ANNEX E – SUMMARY OF THE PRINCIPAL DUTIES OF THE REMUNERATION COMMITTEE

The suggested Code provides that the remuneration committee should consist exclusively of independent non-executive directors and should comprise at least three such directors.

## *Duties*

The Committee should:

- determine and agree with the board the framework or broad policy for the remuneration of the chief executive, the chairman of the company and such other members of the executive management as it is designated to consider<sup>1</sup>. At a minimum, the committee should have delegated responsibility for setting remuneration for all executive directors, the chairman and, to maintain and assure their independence, the company secretary. The remuneration of non-executive directors should be a matter for the chairman and executive members of the board. No director or manager should be involved in any decisions as to their own remuneration;
- determine targets for any performance-related pay schemes operated by the company;
- determine the policy for and scope of pension arrangements for each executive director;
- ensure that contractual terms on termination, and any payments made, are fair to the individual and the company, that failure is not rewarded and that the duty to mitigate loss is fully recognised;<sup>2</sup>
- within the terms of the agreed policy, determine the total individual remuneration package of each executive director including, where appropriate, bonuses, incentive payments and share options;
- in determining such packages and arrangements, give due regard to the comments and recommendations of the Code as well as the UK Listing Authority's Listing Rules and associated guidance;
- be aware of and advise on any major changes in employee benefit structures throughout the company or group;
- agree the policy for authorising claims for expenses from the chief executive and chairman;

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<sup>1</sup> Some companies require the remuneration committee to consider the packages of all executives at or above a specified level such as those reporting to a main board director whilst other require the committee to deal with all packages above a certain figure.

<sup>2</sup> Remuneration committees should consider reviewing and agreeing a standard form of contract for its executive directors, and ensure that new appointees are offered and accept terms within the previously agreed level.

- ensure that provisions regarding disclosure of remuneration, including pensions, as set out in the Directors' Remuneration Report Regulations 2002 and the Code, are fulfilled;
- be exclusively responsible for establishing the selection criteria, selecting, appointing and setting the terms of reference for any remuneration consultants who advise the committee;
- report the frequency of, and attendance by members at, remuneration committee meetings in the annual report; and
- make the committee's terms of reference publicly available. These should set out the committee's delegated responsibilities and be reviewed and, where necessary, updated annually.

This guidance has been compiled with the assistance of ICSA who have kindly agreed to produce updated guidance on their website [www.icsa.org.uk](http://www.icsa.org.uk) in the future.

# ANNEX F – SUMMARY OF THE PRINCIPAL DUTIES OF THE NOMINATION COMMITTEE

All listed companies should have a nomination committee which should lead the process for board appointments and make recommendations to the board.

The nomination committee should consist of a majority of independent non-executive directors. It may include the chairman of the board, but should be chaired by an independent non-executive director.

## *Duties*

The committee should:

- be responsible for identifying and nominating for the approval of the board, candidates to fill board vacancies as and when they arise;
- before making an appointment, the nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment;
- review annually the time required from a non-executive director. Performance evaluation should be used to assess whether the non-executive director is spending enough time to fulfil their duties;
- consider candidates from a wide range of backgrounds and look beyond the “usual suspects”;
- give full consideration to succession planning in the course of its work, taking into account the challenges and opportunities facing the company and what skills and expertise are needed on the board in the future;
- regularly review the structure, size and composition (including the skills, knowledge and experience) of the board and make recommendations to the board with regard to any changes;
- keep under review the leadership needs of the organisation, both executive and non-executive, with a view to ensuring the continued ability of the organisation to compete effectively in the marketplace;
- make a statement in the annual report about its activities; the process used for appointments and explain if external advice or open advertising has not been used; the membership of the committee, number of committee meetings and attendance of members over the course of the year;

- make publicly available its terms of reference explaining clearly its role and the authority delegated to it by the board; and
- ensure that on appointment to the board, non-executive directors receive a formal letter of appointment setting out clearly what is expected of them in terms of time commitment, committee service and involvement outside board meetings.

The committee should make recommendations to the board:

- as regards plans for succession for both executive and non-executive directors;
- as regards the re-appointment of any non-executive director at the conclusion of their specified term of office;
- concerning the re-election by shareholders of any director under the retirement by rotation provisions in the company's articles of association;
- concerning any matters relating to the continuation in office of any director at any time; and
- concerning the appointment of any director to executive or other office other than to the positions of chairman and chief executive, the recommendation for which would be considered at a meeting of the board.

This guidance has been compiled with the assistance of ICSA who have kindly agreed to produce updated guidance on their website [www.icsa.org.uk](http://www.icsa.org.uk) in the future.

# ANNEX G – PRE-APPOINTMENT DUE DILIGENCE CHECKLIST FOR NEW BOARD MEMBERS

## *Why?*

Before accepting an appointment a prospective non-executive director should undertake their own thorough examination of the company to satisfy themselves that it is an organisation in which they can have faith and in which they will be well suited to working.

The following questions are not intended to be exhaustive, but are intended to be a helpful basis of the pre-appointment due diligence process that all non-executive directors should undertake.

## *Questions to ask*

What is the company's current financial position and what has its financial track record been over the last three years?

What are the key dependencies (e.g. regulatory approvals, key licences)?

What record does the company have on corporate governance issues?

If the company is not performing particularly well is there potential to turn it round and do I have the time, desire and capability to make a positive impact?

What are the exact nature and extent of the company's business activities?

Who are the current executive and non-executive directors, what is their background and their record and how long have they served on the board?

What is the size and structure of the board and board committees and what are the relationships between the chairman and the board, the chief executive and the management team?

Who owns the company i.e. who are the company's main shareholders and how has the profile changed over recent years? What is the company's attitude towards, and relationship with, its shareholders?

Is any material litigation presently being undertaken or threatened, either by the company or against it?

Is the company clear and specific about the qualities, knowledge, skills and experience that it needs to complement the existing board?

What insurance cover is available to directors and what is the company's policy on indemnifying directors?

Do I have the necessary knowledge, skills, experience and time to make a positive contribution to the board of this company?

How closely do I match the job specification and how well will I fulfil the board's expectations?

Is there anything about the nature and extent of the company's business activities that would cause me concern both in terms of risk and any personal ethical considerations?

Am I satisfied that the internal regulation of the company is sound and that I can operate effectively within its stated corporate governance framework?

Am I satisfied that the size, structure and make-up of the board will enable me to make an effective contribution?

Would accepting the non-executive directorship put me in a position of having a conflict of interest?

### *Sources of information*

- Company report and accounts, and/or any listing prospectus, for the recent years.
- Analysts' reports.
- Press reports.
- Company web site.
- Any Corporate Social Responsibility or Environmental Report issued by the company.
- Rating agency reports.
- Voting services reports.

Published material is unlikely to reveal wrong-doing, however a lack of transparency may be a reason to proceed with caution.

This guidance has been compiled with the assistance of ICSA who have kindly agreed to produce updated guidance on their website [www.icsa.org.uk](http://www.icsa.org.uk) in the future.

# ANNEX H – SAMPLE LETTER OF NON-EXECUTIVE DIRECTOR APPOINTMENT

On [date], upon the recommendation of the nomination committee, the board of [company] ('the Company') has appointed you as non-executive director. I am writing to set out the terms of your appointment. It is agreed that this is a contract for services and is not a contract of employment.

## *Appointment*

Your appointment will be for an initial term of three years commencing on [date], unless otherwise terminated earlier by and at the discretion of either party upon [one month's] written notice. Continuation of your contract of appointment is contingent on satisfactory performance and re-election at forthcoming AGMs. Non-executive directors are typically expected to serve two three-year terms, although the board may invite you to serve for an additional period.

## *Time commitment*

Overall we anticipate a time commitment of [number] days per month after the induction phase. This will include attendance at [monthly] board meetings, the AGM, [one] annual board away day, and [at least one] site visit per year. In addition, you will be expected to devote appropriate preparation time ahead of each meeting.

By accepting this appointment, you have confirmed that you are able to allocate sufficient time to meet the expectations of your role. The agreement of the chairman should be sought before accepting additional commitments that might affect the time you are able to devote to your role as a non-executive director of the company.

## *Role*

Non-executive directors have the same general legal responsibilities to the company as any other director. The board as a whole is collectively responsible for promoting the success of the company by directing and supervising the company's affairs. The board:

- provides entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed;
- sets the company's strategic aims, ensures that the necessary financial and human resources are in place for the company to meet its objectives, and reviews management performance; and

- sets the company's values and standards and ensures that its obligations to its shareholders and others are understood and met.

In addition to these requirements of all directors, the role of the non-executive has the following key elements:

- **Strategy:** Non-executive directors should constructively challenge and contribute to the development of strategy;
- **Performance:** Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance;
- **Risk:** Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible; and
- **People:** Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning.

### *Fees*

You will be paid a fee of £[amount] gross per annum which will be paid monthly in arrears, [plus [number] ordinary shares of the company per annum, both of] which will be subject to an annual review by the board. The company will reimburse you for all reasonable and properly documented expenses you incur in performing the duties of your office.

### *Outside interests*

It is accepted and acknowledged that you have business interests other than those of the company and have declared any conflicts that are apparent at present. In the event that you become aware of any potential conflicts of interest, these should be disclosed to the chairman and company secretary as soon as apparent.

[The board of the company have determined you to be independent according to the provision of the Combined Code.]

### *Confidentiality*

All information acquired during your appointment is confidential to the Company and should not be released, either during your appointment or following termination (by whatever means), to third parties without prior clearance from the chairman.

Your attention is also drawn to the requirements under both legislation and regulation as to the disclosure of price sensitive information. Consequently you should avoid making any statements that might risk a breach of these requirements without prior clearance from the chairman or company secretary.



## *Induction*

Immediately after appointment, the Company will provide a comprehensive, formal and tailored induction. This will include the information pack recommended by the Institute of Chartered Secretaries and Administrators, available at [www.icsa.org.uk](http://www.icsa.org.uk). We will also arrange for site visits and meetings with senior and middle management and the Company's auditors. We will also arrange for you to meet major investors in the first twelve months of your appointment.

## *Review process*

The performance of individual directors and the whole board and its committees is evaluated annually. If, in the interim, there are any matters which cause you concern about your role you should discuss them with the chairman as soon as is appropriate.

## *Insurance*

The Company has directors' and officers' liability insurance and it is intended to maintain such cover for the full term of your appointment. The current indemnity limit is £ [amount]; a copy of the policy document is attached.

## *Independent professional advice*

Occasions may arise when you consider that you need professional advice in the furtherance of your duties as a director. Circumstances may occur when it will be appropriate for you to seek advice from independent advisors at the company's expense. A copy of the board's agreed procedure under which directors may obtain such independent advice is attached. The Company will reimburse the full cost of expenditure incurred in accordance with the attached policy.

## *Committees*

This letter refers to your appointment as a non-executive director of the Company. In the event that you are also asked to serve on one or more of the board committees this will be covered in a separate communication setting out the committee(s)'s terms of reference, any specific responsibilities and any additional fees that may be involved.

This sample appointment letter has been compiled with the assistance of ICSA who have kindly agreed to produce updated guidance on their website [www.icsa.org.uk](http://www.icsa.org.uk) in the future.



# ANNEX I – INDUCTION CHECKLIST

## *Guidance on induction*

Every company should develop its own comprehensive, formal induction programme that is tailored to the needs of the company and individual directors. The following guidelines might form the core of an induction programme.

As a general rule, a combination of selected written information together with presentations and activities such as meetings and site visits will help to give a new appointee a balanced and real-life overview of the company. Care should be taken not to overload the new director with too much information. The new director should be provided with a list of all the induction information that is being made available to them so that they may call up items if required before otherwise provided.

The induction process should:

1. Build an understanding of the **nature of the company, its business and the markets in which it operates**. For example, induction should cover:
  - the company's products or services,
  - group structure / subsidiaries /joint ventures,
  - the company's constitution, board procedures and matters reserved for the board,
  - summary details of the company's principal assets, liabilities, significant contracts and major competitors,
  - the company's major risks and risk management strategy,
  - key performance indicators, and
  - regulatory constraints.
  
2. Build a link with the **company's people** including:
  - meetings with senior management,
  - visits to company sites other than the headquarters, to learn about production or services and meet employees in an informal setting. It is important, not only for the board to get to know the new non-executive director, but also for the non-executive director to build a profile with employees below board level, and
  - participating in board strategy development. 'Awaydays' enable a new non-executive director to begin to build working relationships away from the formal setting of the boardroom.

3. Build an understanding of the **company's main relationships**, including meeting with the auditors and developing a knowledge of in particular:
- who are the major customers,
  - who are the major suppliers, and
  - who are the major shareholders and what is the shareholder relations policy – participation in meetings with shareholders can help give a first hand feel as well as letting shareholders know who the non-executive directors are.

### *The induction pack*

On appointment, or during the weeks immediately following, a new director should be provided with certain basic information to help ensure their early effective contribution to the company. ICSA has produced, and undertaken to maintain, on their website [www.icsa.org.uk](http://www.icsa.org.uk) a guidance note detailing a full list of such material.

# ANNEX J – PERFORMANCE EVALUATION GUIDANCE

## *Guidance on performance evaluation*

This Review recommends that the Code is updated to reflect best practice that the performance of the board as a whole, of its committees, and of its members, is evaluated at least once a year. Companies should disclose in their annual report whether such performance evaluation is taking place.

It is the responsibility of the chairman to select an effective process and to act on its outcome. The use of an external third party to conduct the evaluation will bring objectivity to the process.

The evaluation process will be used constructively as a mechanism to improve board effectiveness, maximise strengths and tackle weaknesses. The results of board evaluation should be shared with the board as a whole, while the results of individual assessments should remain confidential between the chairman and the non-executive director concerned.

The following are some of the questions that should be considered in a performance evaluation. They are, however, by no means definitive or exhaustive and companies will wish to tailor the questions to suit their own needs and circumstances.

The responses to these questions and others should enable boards to assess how they are performing and to identify how certain elements of their performance areas might be improved.

## *Performance evaluation of the board*

- How well has the board performed against any performance objectives that have been set?
- What has been the board's contribution to the testing and development of strategy?
- What has been the board's contribution to ensuring robust and effective risk management?
- Is the composition of the board and its committees appropriate, with the right mix of knowledge and skills to maximise performance in the light of future strategy? Are inside and outside the board relationships working effectively?
- How has the board responded to any problems or crises that have emerged and could or should these have been foreseen?
- Are the matters specifically reserved for the board the right ones?
- How well does the board communicate with the management team, company employees and others? How effectively does it use mechanisms such as the AGM and the annual report?

- Is the board as a whole up to date with latest developments in the regulatory environment and the market?
- How effective are the board's committees? (Specific questions on the performance of each committee should be included such as, for example, their role, their composition and their interaction with the board.)

The processes that help underpin the board's effectiveness should also be evaluated e.g.:

- Is appropriate, timely information of the right length and quality provided to the board and is management responsive to requests for clarification or amplification? Does the board provide helpful feedback to management on its requirements?
- Are sufficient board and committee meetings of appropriate length held to enable proper consideration of issues? Is time used effectively?
- Are board procedures conducive to effective performance and flexible enough to deal with all eventualities?

In addition, there are some specific issues relating to the chairman which should be included as part of an evaluation of the board's performance e.g.:

- Is the chairman demonstrating effective leadership of the board?
- Are relationships and communications with shareholders well managed?
- Are relationships and communications within the board constructive?
- Are the processes for setting the agenda working? Do they enable board members to raise issues and concerns?
- Is the company secretary being used appropriately and to maximum value?

### *Performance evaluation of the non-executive director*

The chairman and other board members should consider the following issues and the individual concerned should also be asked to assess themselves. For each non-executive director:

- How well prepared and informed are they for board meetings and is their meeting attendance satisfactory?
- Do they demonstrate a willingness to devote time and effort to understand the company and its business and a readiness to participate in events outside the boardroom, such as site visits?
- What has been the quality and value of their contributions at board meetings?

- What has been their contribution to development of strategy and to risk management?
- How successfully have they brought their knowledge and experience to bear in the consideration of strategy?
- How effectively have they probed to test information and assumptions? Where necessary, how resolute are they in maintaining their own views and resisting pressure from others?
- How effectively and proactively have they followed up their areas of concern?
- How effective and successful are their relationships with fellow board members, the company secretary and senior management? Does their performance and behaviour engender mutual trust and respect within the board?
- How actively and successfully do they refresh their knowledge and skills and are they up to date with:
  - the latest developments in areas such as corporate governance framework and financial reporting?
  - the industry and market conditions?
- How well do they communicate with fellow board members, senior management and others, for example shareholders. Are they able to present their views convincingly yet diplomatically and do they listen and take on board the views of others?





# ANNEX K – TERMS OF REFERENCE FOR THE REVIEW

## *Objective*

Building on the work of the Company Law Review and the Myners Review, the Government has commissioned Derek Higgs to lead a short independent review of the role and effectiveness of non-executive directors in the UK.

## *Background*

Non-executive directors play a central role in UK corporate governance. The Company Law Review noted “a growing body of evidence from the US suggesting that companies with a strong contingent of non-executives produce superior performance”.

In the decade since the introduction of the Cadbury Code, the role of non-executives has undoubtedly strengthened.

From the point of view of UK productivity performance, progressive strengthening of the quality and role of non-executives is strongly desirable.

## *Proposal*

Though the Government has an open mind, its preferred starting-point in this area is, if possible, an approach based on best practice, not regulation or legislation.

The Government believes it would be valuable for a senior independent figure from the business world, building on the work of the Company Law Review, of Myners, and of the Institute of Directors and others, to undertake a review to assess:

- the population of non-executive directors in the UK – who are they, how are they appointed, how the pool might be widened etc;
- their “independence”;
- their effectiveness;
- accountability; their relationship – actual and potential – with institutional investors;
- issues relating to non-executive directors’ remuneration;
- the role of the Combined Code;
- what, if anything, could be done – by individual boards, by institutional investors, by the Government or otherwise – to strengthen the quality, independence and effectiveness of non-executive directors.

The review will look at these questions in an international context.

The aim of the review is:

- to build and publish an accurate picture of the status quo;
- to lead a debate on these issues, especially in the business and financial worlds; and
- to make any recommendations – to Government or others – which the reviewer thinks appropriate.

## ANNEX L – USEFUL WEB LINKS

Further information on the Review, together with full details of the research conducted for the Review, and copies of consultation responses can be accessed at:

[http://www.dti.gov.uk/cld/non\\_exec\\_review](http://www.dti.gov.uk/cld/non_exec_review)

The Cadbury, Greenbury and Hampel Reports and the Combined Code can be accessed at:

[http://www.ecgi.org/codes/country\\_pages/codes\\_uk.htm](http://www.ecgi.org/codes/country_pages/codes_uk.htm)

Corporate governance Codes in other countries, referred to in this report can be viewed at:

[http://www.ecgi.org/codes/all\\_codes.htm](http://www.ecgi.org/codes/all_codes.htm)

Information on the Company Law Review and the Company Law White Paper can be accessed at:

<http://www.dti.gov.uk/cld/>

The report of the EU High Level Group of Company Law Experts (the “Winter group”) can be accessed at:

[http://europa.eu.int/comm/internal\\_market/en/company/company/modern/index.htm](http://europa.eu.int/comm/internal_market/en/company/company/modern/index.htm)

The Myners Report on Institutional Investment in the UK can be accessed at:

[http://www.hm-treasury.gov.uk/Documents/Financial\\_Services/Securities\\_and\\_Investments/fin\\_sec\\_mynfinal.cfm](http://www.hm-treasury.gov.uk/Documents/Financial_Services/Securities_and_Investments/fin_sec_mynfinal.cfm)

Copies of guidance produced by the Institute of Chartered Secretaries and Administrators can be accessed at the ICSA web site:

<http://www.icsa.org.uk>





