

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

Consultation Paper

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Derek Higgs

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Non-Executive Directors Review
Room 2142
1 Victoria Street
London SW1H 0ET

Telephone Enquiries: 020 7215 3917

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REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS: A CONSULTATION PAPER

Introduction

1. I have been asked to lead a short, independent review of the role and effectiveness of non-executive directors. The crucial role played by non-executive directors in improving company performance and accountability is widely recognised. In the UK, we have already made significant progress in strengthening corporate governance. In particular, there has been considerable debate about the role played by non-executive directors. I am keen to build on the valuable work already undertaken by a number of individuals and organisations in this area.
2. My terms of reference are at Annex A. I plan to complete my report by around the end of the year.
3. I will be considering not just possible recommendations for Government or regulators, but also for action by individual boards, by institutional investors or by others. The Government has stated that an approach based on best practice rather than regulation or legislation is its preferred starting point, and this is also my own view.
4. I hope that we can move the debate forward by establishing a clearer picture of the way boards operate today, and the contribution of non-executive directors. I will then seek to identify what more might be done to strengthen the quality, independence and effectiveness of non-executive directors. In reaching conclusions I shall seek to reinforce the positive achievements of the best practice embodied in the Combined Code with tangible measures to promote more effective boards.
5. This consultation document lays out the key questions and issues as I see them. They are not however meant to be exclusive. I would very much welcome other suggestions or comments. I hope that I will receive responses from a range of perspectives, as I am keen to understand different views and to promote a wide-ranging public debate. I therefore very much hope that you will contribute to the Review.

Responding to the Review

6. The deadline for responses is **Friday 6th September**.
Please email or post responses to this consultation paper to:

Email: non-exec.review@dti.gov.uk

Address:

Non-Executive Directors Review,
Room 2142,
1 Victoria Street,
London SW1H 0ET

Telephone enquiries: 020 7215 3917

7. Responses will be regarded as being on the public record and may be disclosed unless you ask us to regard your response as confidential. This document is available on the DTI website at www.dti.gov.uk/cld/non_exec_review, where any follow-up documents relating to the Review will appear in due course.

Background

8. Non-executive directors play a central role in corporate governance in UK companies. From the point of view of UK productivity and competitiveness, the progressive strengthening of the role of non-executive directors is strongly desirable.
9. There have undoubtedly been improvements in the role and effectiveness of non-executive directors over the last decade, as companies' corporate governance arrangements have increasingly come under scrutiny. Much of this improvement is attributable to the development and subsequent refinement of the Combined Code. This was the culmination of work initiated by Sir Adrian Cadbury's Committee in 1992, and supplemented by the Greenbury Review in 1995 and the Hampel Review in 1998.
10. The Code sets out best practice, for example on board and committee balance, including the role of independent non-executive directors. 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. The Financial Reporting Council now has responsibility for overseeing the Code.
11. Two recent reviews are also of relevance to this Review. The independent Company Law Review (CLR), whose final report was published in July 2001, made wide-ranging proposals to simplify and modernise company law. The CLR proposed that a general statement of directors' duties should be set out in legislation. The Government is currently considering the CLR recommendations.
12. The Myners Report looked at investment decision-making in the UK. The Government is considering how to take forward proposals to strengthen the duties of institutional investors.
13. There is no statutory definition of a non-executive director. Non-executive directors are however generally regarded as those directors who, unlike their executive colleagues, do not hold any executive or management position in the company in addition to their role as a member of the board. Like other directors of a company, non-executive directors have to comply with the duties of directors which have been established by common law and case law, such as the duty to exercise care, skill and diligence.
14. As regards the role played by non-executive directors, the Cadbury Committee made the following observations:

“4.4 Whilst it is the board as a whole which is the final authority, executive and non-executive directors are likely to contribute in different ways to its work. Non-executive directors have two particularly important contributions to make to the governance process as a consequence of their independence from executive responsibility. Neither is in conflict with the unitary nature of the board.

4.5 The first is in reviewing the performance of the board and of the executive. Non-executive directors should address this aspect of their responsibilities carefully and should ensure that the chairman is aware of their views. If the chairman is also the chief executive, board members should look to a senior non-executive director, who might be the deputy chairman, as the person to whom they should address any concerns about the combined office of chairman/chief executive and its consequences for the effectiveness of the board. A number of companies have recognised that role and some have done so formally in their Articles.

4.6 The second is in taking the lead where potential conflicts of interest arise. An important aspect of effective corporate governance is the recognition that the specific interests of the executive management and the wider interests of the company may at times diverge, for example over takeovers, boardroom succession or directors' pay. Independent non-executive directors, whose interests are less directly affected, are well-placed to help to resolve such situations."

The Hampel Review, six years later, observed:

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

15. Links to key reviews and documents relevant to the role of non-executive directors can be found in Annex B.

Issues for consideration

16. The key issues I have identified are set out below, but comments on all other relevant matters would also be welcome. Clearly each company and boardroom has its own distinct characteristics and it is right to be cautious about generalisations. But it will be helpful to build as clear a description of how boards function today as possible, not only amongst larger listed companies but also in the mid-cap and smaller listed sectors. This will provide a useful base for debate on the steps which could be taken to improve board effectiveness and corporate performance.

17. The issues on which I would welcome views are:

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

B What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?

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

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

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

In relation to all of the above we need to consider the following two aspects:

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

G What can we learn from international experience?

18. **Comments are invited on these issues.** In order to promote debate I have posed a series of questions on each issue, which may be of help in formulating your response. In each of the areas it would be valuable to hear your views of the current position and your ideas for change and improvement. I would also like to hear of any other suggestions for what 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.

A: Role

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

Possible issues for comment:

1. What is the role of the board? What is the role of the Chairman and how does it relate to the non-executive directors?
2. What should be the key roles of non-executive directors on the board and what should be the balance between the different components? Within a board, should all non-executive directors be expected to fulfil each of the different roles?
3. How does this compare to the present position?
4. How independent do non-executive directors need to be for the different roles?
5. What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a role in protecting the interests of the company? What can be done to help non-executive directors to be effective in relation to these conflicts?
6. What time commitment is needed for the role of Chairman and for non-executive director roles, and how far does this vary between different companies? Are there any implications for the number of non-executive posts that one person can sensibly take on?
7. Should there be a special role for a "senior independent" non-executive director?
8. Do you have comments on the proposed statutory statement of directors' duties, which does not seek to distinguish between the legal duties of executive and non-executive directors?

B: Attracting and appointing non-executives

What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?

Possible issues for comment:

9. What are the key skills, knowledge and experience which are needed by non-executive directors to perform the role effectively, and how is this likely to change over the next, say, 10 years? Are some skills essential and, if so, what are they?
10. What personal qualities and attributes are needed?
11. What sort of mix of experience and attributes is desirable on a Board? Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.
12. How easy is it to recruit non-executive directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?
13. What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?
14. Are the rewards for non-executive directors appropriate, both in terms of levels of pay and the form that remuneration takes – e.g. cash/shares/share options? Are current pay levels a significant factor in whether good non-executive directors can be attracted?
15. Do you have comments on the issue of risks or insurance provision for non-executive directors?

C: Structures and accountability

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

Possible issues for comment:

16. How is the Combined Code working in practice? In particular, how are the provisions on the balance between executive and non-executive directors and the role of independent non-executive directors working? Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?
17. Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors? Are board meeting procedures working effectively? Do you have comments on board size?
18. Do you have comments on the composition and duties of Audit Committees? How effectively are Audit Committees working in practice? Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?
19. Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?
20. What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?
21. Could more be done to review performance? Should more information on board performance be reported to shareholders? Should companies provide more information on the performance of non-executive directors?
22. Are non-executive directors able successfully to challenge executive decisions or expose serious problems? Should it be made easier for them to do so and, if so, how?

D: Relationships with shareholders and others

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

Possible issues for comment:

23. How well do relationships between non-executive directors and shareholders and stakeholders work, and could they be improved? For example, we would be interested to hear views on what the relationship might be between non-executive directors and institutional shareholders. How could this relationship be strengthened?
24. To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more that they could do, by promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows, or otherwise?
25. What should be the relationship between non-executive directors and executive directors, and with senior management? What should their relationship be with the Chairman and the Chief Executive? What should their relationship be with key advisers to the company?
26. How can Company Secretaries support effective performance by non-executive directors?

E: Support

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

Possible issues for comment:

27. How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?
28. What training and development opportunities are available? Could they be improved and, if so, how?
29. Can induction for non-executive directors be improved?
30. Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?

F: Smaller listed companies

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

Possible issues for comment:

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

G: International context

What can we learn from international experience?

Possible issues for comment:

32. What lessons can be learnt from international experience, either in terms of structures or behaviours?
33. Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?
34. Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?

ANNEX A

REVIEW TERMS OF REFERENCE

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 B REFERENCES IN THE TEXT

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

http://www.ecgi.org/codes/country_pages/codes_uk.htm

The relevant chapters of the Company Law Review consultation documents and final report can be accessed as follows:

‘Developing the Framework’ Chapter 3

http://www2.dti.gov.uk/cld/claw_2_3.pdf

‘Completing the Structure’ Chapters 3 and 4

http://www2.dti.gov.uk/cld/reviews/cs_chapt_3.pdf

http://www2.dti.gov.uk/cld/reviews/cs_chapt_4.pdf

‘Final Report’ Chapter 6

http://www2.dti.gov.uk/cld/final_report/ch_6.pdf

The Myners Report can be accessed at:

http://www.hm-treasury.gov.uk/Documents/Financial_Services/Securities_and_Investments/fin_sec_mynfinal.cfm

