

Comments on behalf of

The Association of Corporate Treasurers

in response to the Consultation Paper (7 June 2002) for the

Review of the role and effectiveness of non-executive directors

I. Introduction

The Association

The Association of Corporate Treasurers was formed in 1979 to encourage and promote the study and practice of finance and treasury management and to educate those involved in the field.

Today, it is an organisation of professionals in corporate finance, risk and cash management operating internationally. It has over 3,000 fellows, members and associate members. With more than 1,200 students in more than 40 countries, its education and examination syllabuses are recognised as the global standard setters for treasury education.

Members adhere to the Association's ethical code and professional ethics are included as part of the membership examination syllabus.

The Association has published in its series "The business of finance" a number of guides on finance and treasury issues for directors, executive and non-executive, with an accounting or other non-financial background.

Members of the Association work in many fields. A number of members are on the boards of major companies in both executive and non-executive capacities. For example, certain former members of the Association's Council are Chairmen of some of the largest quoted European companies. The majority of fellows, however, are professionals working as senior executives below the board level in large public companies, responsible for the treasury and corporate finance functions.

Perspectives from the board and from senior management below the board inform our comments.

This Review

The ACT welcomes the opportunity to submit views on this important topic about which our members commonly have strong feelings.

We would be pleased to further expand any point made herein or to assist the Review in any other way.

II. Summary

- i. Improving corporate governance in the UK is now much more a question of people and attitudes than new regulation. We do not believe that the UK model of corporate governance is broken: we do not know of a better model elsewhere in the world.

Codes of best practice and an atmosphere of general comment and interest from the community at large, without obsession, remain the way forward.

Good people are required to make any system work well, and can greatly improve the working of bad systems. The wrong people can cause major difficulties within the best of structures.

We suggest ways in which numbers of good, independent, non-executives can be increased.

Non-executive directors' main roles are those of strategic support and monitoring of management – executive directors – in a unitary board. Their independence from important potential conflicts of interest which can affect executive directors is fundamental. We set out many examples of such conflict of interest. What is required to be independent will evolve over the years. We suggest some ways of refining of the concept which would be helpful now.

We suggest attitudes and practices which would improve the effectiveness of company chairmen, who should be numbered among the independent non-executive directors. The latter need to be in sufficient numbers (a simple majority of the board) and to have the firmness of purpose to require suitable information flows from executive management. They must give the time to understand, and bring an ability to use, the information provided. Companies need to invest in supporting and developing the abilities of their non-executive directors if they are to get the best out of them. We highlight one key area in which most non-executives need education if they are to be effective.

The number of non-executive posts a person can hold is very limited. Persons in full-time work probably cannot take on more than one non-executive directorship – and that only with the cooperation of their employers/firms.

Non-executives need adequate reward for their time and skills but moderation in total reward and avoidance of some forms of remuneration are required if they are to be truly independent. For this reason, the potential financial liabilities which they incur from their position must be limited – if they have acted in good faith, with reasonable diligence, and not recklessly. It is neither practical nor desirable to protect them from the reputational risk of involvement with a company.

We highlight some problems with the proposed code of directors' duties included in the recent draft Companies Bill, although in principle such a code can be a useful tool.

No group of non-executives, however independent, skilled or diligent, is able to protect against a management which is resolved to conceal or mislead.

ii. Main points and recommendations

1. Regulation/best practice codes

We do not see a need for new regulation in general, but do suggest improvements to best practice recommendation at several places

2. Unitary boards

We support the unitary nature of the board of directors. (See issue 2c)

3. Risks

Director appreciation of risk issues is vital.

A key responsibility of a company's board is to ensure that the overall risk in the company is controlled and remains within the range the board has selected – and that significant changes are made known to the market and the public generally.

4. Unitary boards

Within the unitary board we believe that the position of independent non-executive directors is important and we would toughen the detailed codes on what prevents true independence. (See issue 4)

We believe that independent non-executive directors should constitute a majority of the board.

5. Chairmen

The Chairman should be numbered among the independent non-executive directors. The exception in the Combined Code permitting the roles of Chairman and Chief Executive to be combined should be abolished. (See issues 2.a and 16.b)

6. Director induction/training

All directors should be introduced to their responsibilities as directors – legal and under the various best practice codes – on first appointment. A qualified company secretary should keep them updated of changes in the requirements. Non-executive directors should also have a programme to familiarise themselves with the company and its risk environment. Few directors do not need some education about risks and dependencies in any projections of the future and how the overall risk in the company can be managed.

7. A second senior non-executive director

It is important that there be a nominated senior independent non-executive director apart from the Chairman. This would normally be the Deputy Chairman. (See issue 7)

8. Time commitment/limits on number of positions

Directors must limit positions in the light of time available.

- **Chairmen**

It would be difficult for a Chairman to chair more than one other unrelated company or, alternatively, to have more than a couple of non-executive posts on boards of non-related companies. The ABI/NAPF code should be adapted accordingly. (See issue A.6.a)

- Someone in substantially full-time employment cannot give sufficient time for more than one, un-related independent non-executive directorship.

- Other independent non-executive directors must be guided by circumstances, but we believe the NAPF guidance of a maximum of 5 concurrent appointments is generous.
(See issue 6)

9. Non-executive roles

We do not advocate different roles for different non-executives, the Chairman and Deputy Chairman apart.

10. Board committees

All independent non-executive directors should be entitled to attend any meeting of any committee, even if they are not actually a member of it. (See issue 2)

The Association would urge that the Combined Code stipulations for non-executive director membership of specified board committees be changed to specify independent non-executive directors. (See issue 17.a)

11. Internal Audit

We believe that the relationship between the Audit Committee and internal audit function should be strengthened (See issue 18.b)

12. Non-executive remuneration

Non-executive directors' independence can be destroyed by issuing them with options or schemes which vest shares or grant shares or material bonuses dependent upon company reported performance and/or share price. Codes of best practice should deprecate use of such forms of remuneration.

13. Executive director remuneration

The Association supports the right of shareholders to vote on contracts including remuneration packages of executive directors.

14. Risks

Non-executive directors need indemnities from the company and also to be included in the company's "Directors and Officers" policy. They need the availability of "top-up" policies. Much further study is needed of the possibilities of limiting personal liabilities to realistic levels. (See issue 15)

15. Proposed statutory statement of directors duties

We believe that, subject to some important re-drafting, the statement can be helpful. As regards benefits from third parties, we believe that if regulation is required, it be confined to requiring companies to adopt and publish a code of practice to be followed by directors. (See issue 8)

16. Skills, qualities, experience of non-executive directors

The Association believes that the personal qualities of candidates are the key and generally more important than particular expertise. We make a number of important observations about expertise required. (See issues 9/10/11)

17. Widening the pool of potential non-executives

Regular public comment from institutional investors or the bodies representing classes of them about the need to recruit more widely is probably the fastest way to free up the situation and extend the search. Attitudes of recruitment agencies are the biggest stumbling block.

Divisional or large subsidiary company boards or the policy making groups of

particular functions in large multinational companies, or the boards of not-for-profit organisations are useful areas for prospecting.

As independent non-executives are to bring a broad, balanced judgement, stakeholders as such are not suitable candidates – though individual stakeholders may be. Greater international representation on UK boards is only a marginal contributor to widening the pool of potential non-executives. (See issues 12, 13)

18. International lessons about behaviour or structures

We believe that the UK system of corporate governance, with unitary boards, which meet frequently and include independent non-executives, is inherently potentially superior to other models.

III. General comments

i. These comments

The consultation paper asks in places for instances or company experiences. While The Association in its consultations is aware of many, the circumstances would too often identify the particular company, and hence individuals, and so none are quoted.

These comments follow in the main the sections and headings used in the Consultation Paper and section IV follows the consultation paper numbering.

We have included some discussion to give the rationale or background to normative comments. Principal comments and recommendations are emboldened in the text.

It is appropriate to set out some general matters first.

ii. The general framework for non-executive directors

The Association believes that, in general, the framework of regulation and the Combined Code, supported by best practice advice, is working well.

The current system is relatively new and its adoption becomes more effective and less cosmetic with the passage of time and as people become accustomed to it.

We do not advocate new regulation in general, but do suggest improvement of best practice recommendations in some cases.

iii. Independent non-executive directors

In these comments we distinguish independent from non-independent non-executive directors. Unless otherwise specified, we treat non-independent non-executives with executive directors.

iv. Accountability of companies

Many commentators have referred to the accountability of companies to shareholders especially among a wide range of stake-holders.

However, for the purposes of these comments we will focus on two accountabilities, whether legal or moral (see issue 5, below):

- Accountability to shareholders, as owners of the company
- Accountability, arising from the company's use of the privilege of limited liability, to others dealing with company or to whom it may incur liabilities.

v. The position of professionally qualified members of the board and of other professionals employed by the company

Members of professional bodies related to corporate governance and finance are governed by the professional code of those professional bodies. Such bodies usually have provision for "continuing professional education" after members' initial examinations, and an appropriate ethical code.

High standards of conduct and knowledge of legal and regulatory requirements and generally accepted “best practice” can thus be expected from such members. In the current context, as the courts will consider the general knowledge, skill and experience that a director has, they will look for high standards in these areas from relevantly qualified professionals who are directors.

Professionals generally are expected to be more aware of potential or actual conflicts of interest – for themselves or for colleagues and of possible enrichment or other misconduct or conflict of interest by those around them. Commentators on the recent corporate scandals in the United States have drawn attention to the general failure of “professionals” at board level and below in the affected companies either to refrain from malpractice themselves or to “blow the whistle” on others (see issue A.5.d.2, below). We note that the equivalents of finance directors of US companies, in the main, are not members of professional bodies.

It is very important that arrangements and structures in a company right up to board level support and give mechanisms/channels for professionals to take correct action in such cases. In the UK many companies have such arrangements and it is best practice. Non-executive directors have a potentially key role in this context. This is discussed at several points below (see issues 5, 7, 25).

vi. The “crucial role” of non-executive directors

Paragraph 1 of the Introduction of the Consultation Paper refers to the wide recognition of the crucial role of non-executive directors. We would like to believe this to be true, but are aware of scepticism today in many quarters.

Institutional shareholders were slow to pressure companies to follow the Cadbury and later codes, but they seem more active today. They need to press non-executives to be effective in their role and not passive “free riders”.

Support for the role tends to be based on a theoretical reasoning and anecdote. Some soundly based academic studies investigating if *independent* non-executive directors do actually improve company performance and accountability, over the long term, would be welcomed.

vii. Companies

The Review terms of reference, Appendix A, refer to companies generally, but paragraph 16 which opens the *Issues for consideration* section refers only to listed companies. **We believe that the principles of the Combined Code and those we set out in these comments set the standards for all corporate enterprises.** The Schedule to the draft Companies Bill which sets out general principles by which Directors are bound applies to all companies, of course.

viii. Non-executives on subsidiary company boards

Non-executives are often appointed to subsidiary company boards. Much of these comments apply to such non-executive directors.

IV: A: Role of non-executive directors

A.1 Role of the board and Chairman

A.1.a Role of the Board

The board governs the company; the executive management manages it.

The role of the board is to provide strategic direction to the management and to take reasonable steps to monitor and encourage management's performance and its compliance with those directions. Strategy in this context includes not only markets addressed and how they are addressed but risk, financial, investment, manufacturing, sourcing, personnel etc strategies too. Strategic direction includes assessing (with management's help) all aspects of material risk, within the company or arising in its environment, and deciding whether and how to manage it.

When necessary, the board is responsible for replacing the executive management.

The board may also have specific statutory obligations regarding for example pollution or health and safety.

Very importantly and less often remarked, the board is also responsible for the company's accountability, statutory and moral, to shareholders as owners of the company and its moral duty to the public in general not to abuse its use of the privilege of limited liability.

The Association is particularly aware of two of the board's responsibilities stemming from this accountability:

- i. to ensure that an appropriate system of internal control operates**
 - throughout the company and,
 - in the case of groups, throughout the group¹; and
- ii. to ensure that, more broadly, the overall risk in the company is**
 - within the range the board itself has selected and,
 - corresponds to what the shareholders (and the public at large) have been led to expect from the company's general business, its published statements etc.,**and that significant changes in risk are made known in timely fashion to the market and the public.**

The responsibility ii, concerning risk, is insufficiently regarded and missing from most guidance to directors – yet failure to attend to it, inadvertent or reckless, can lead to corporate disaster.

The roles and responsibilities of the board are the key factor in determining appropriate organisation of the board and the skill sets and experience of its members (see issue 5).

¹ See Combined Code, principle D.2,

A.1.b Role of the Chairman

A.1.b.1 Independent non-executive

In light of The Association's views on the role of independent non-executive directors (see below), it follows that it supports the concept that **Chairmen should themselves be independent non-executive directors.**

It is important that the Chairman is not a former (chief) executive of the company, as that may inhibit discussion or review of decisions taken (or avoided) during their incumbency.

A.1.b.2 Chairman's role

The Chairman's role is considered as:

- (a) providing leadership to the board, including setting the agenda for board meetings, after receipt of advice from the executive and company secretary,
- (b) having the ear of the other independent non-executive directors,
- (c) being the interface, day-to-day, between the board and the chief executive and any other executive directors, and
- (d) being a regular and frequently available point of contact for shareholders, especially institutions.

If necessary, it is the Chairman's role to initiate the dismissal of the chief executive and the finding of his successor.

The (other) independent non-executive directors should look to the Chairman for leadership, but also feel free to contact him on their own initiative to raise concerns, ideas, etc. concerning the company or its management. The Chairman would be the other non-executives main channel to the executive directors.

We comment below (see issue E.30) about the Chairman's role in giving feedback to other non-executive directors, individually, about their contribution.

The Chairman must ensure that other non-executive directors have full opportunity to consider matters brought to the board and to raise questions and to get appropriate answers – even if this would involve the executive directors or their staffs in some work. We quote with approval the Combined Code on this matter (provision A.4.1):

Management has an obligation to provide the board with appropriate and timely information, but information volunteered by management is unlikely to be enough in all circumstances and directors should make further enquiries where necessary. The chairman should ensure that all directors are properly briefed on issues arising at board meetings.²

The company secretary should be available to all non-executive directors as a channel of communication with the company.

² We note the New South Wales Court of Appeal (1995) 13 ACLC 614, 662: "In our opinion the responsibilities of directors require that they take reasonable steps to place themselves in a position to guide and monitor the management of the company". In this country, the recently published draft Companies Bill requires directors to be "reasonably diligent".

The Chairman also has an important practical and symbolic role. That is in chairing company meetings and providing an alternative public face for the company from that of the CEO. It is important that the executive and the CEO in particular are seen to be the company's servants and not its embodiment. Where this has not been the case, powerful personalities can sometimes take a dominating role with few checks. The US experience, where combination of Chairman and CEO roles is common or the CEO appoints the Chairman, illustrates the risk of abuse.

A.2 Key roles of the non-executive directors

A.2.a Role of non-executive directors

A.2.a.1 Key roles of non-executive directors

Non-executive directors have three key roles:

- To provide advice to and a “sounding board” for management
- To participate in strategy development, policy making and risk supervision
- To participate in monitoring of management

A.2.a.2 Executive directors: involvement

The role of executive directors as executives is to propose strategies and suitable organisation of the company, and to manage the company in pursuit of those strategies. Executive directors as executives of the company will do that with enthusiasm and may accordingly be caught up in the “thrill of the chase”. This will also be true when executives are reporting on the progress on projects and the company as a whole, where the temptation to view through rose tinted spectacles and to minimise set-backs is manifest.

Executive directors, as members of the board, participate in evaluation of those same strategies and in monitoring performance. Conscious of their responsibilities as directors when sitting as a board, however, good executive directors will seek to rise above their immediate involvement and to carry out the directorial responsibility with a cool head. This is immensely difficult.

A.2.a.3 Non-executives: cool appraisal

The key role of the non-executives should be to bring an independent judgment to bear on management's proposals and performance. Common sense is the most valuable attribute, together on occasion with a good dose of scepticism, especially where the proposition in question may give executive directors conflicts of interests. Non-executives can thus contribute more coolly to strategy development, to the evaluation of strategic proposals and to strategic decisions. Similar considerations apply too in the evaluation of reports monitoring performance of the company.

Over and above this, they can help ensure that the roles of the board which The Association has highlighted (strategy/policy, internal control and risk) are properly observed.

Part of the accountability to shareholders is in evaluating the performance of the board, and the executive directors - the chief executive in particular.

A.2.a.4 Non-executives: avoidance of conflict of interest

In all of these roles, independent non-executive directors would be expected to have very many fewer conflicts of interest than executive directors (see below).

The Chairman must be found among the independent non-executive directors. This is so that the controller of the board meeting, the Chairman, should not himself be subject to conflict of interest.

A.2.a.5 Non-executives: being *the* expert - not a role

Independent non-executive directors bring many qualities to a board. However, they should not be seen as bringing *the* expertise in a particular area to the company – i.e. being the only or the authoritative source to the company of that expertise. This would prevent their being objective evaluators and appraisers of matters involving that area. A non-executive director carrying out such an expert role for a company should not, in looking at the balance of the board, count among independent non-executives.

The non-executive-director expert can, of course, be very helpful to the board, even if only drawing attention to something needing looking into (and see comments in section B below) or giving incidental advice. However, if the company lacks that expertise among the executive directors or their staffs, it should be bought in from an adviser or consultant. The independent non-executive board member's role is then to participate in examining the executives' proposals (even if only to do nothing) which may as a result of the external advice received.

The Association thus would qualify the Hampel Review's apparent endorsement of the role of independent non-executives contributing "valuable expertise *not otherwise available to the company*" (emphasis added).

A.2.a.6 Appointments and remuneration of executive directors and senior executives below board level

Because of the wide freedom in managing the company necessarily given to executive directors, their appointment and remuneration is a key concern of non-executive directors.

Executive directors will recruit senior staff and inevitably will tend to recruit in their own image. It is very significant, for example, that at the scandal ridden Enron in the United States, the CFO turned to his deputy when appointing someone to manage the special purpose vehicles which, it seems, not only distorted financial reporting but led to enrichment of corporate officers and friends at the expense of shareholders and others. **A proper mechanism for board appointments and for ensuring appropriate procedures for key appointments below board level is a key part of internal control as well as good governance generally.**

Independent non-executive directors must ensure that remuneration of executive directors is reasonable and appropriate and that no aspects of remuneration schemes give perverse incentives or excessive pressure to "deliver" particular results. They must also ensure that remuneration

schemes for senior executives below board level are similarly reasonable and free of perverse incentives.

A.2.b Balance between executive and non-executive directors

While personalities can make almost any arrangement work, the requirements of accountability of the board of a company mean that more reliable structures should be required.

Accordingly, The Association believes that the Chairman and the other independent non-executive directors should make up a simple majority of a public company's board.

Such an arrangement means that the executive will be more likely to need to make proper presentation and explanation of the issues on any matter for consideration by the board. Open discussion that this engenders, under a good Chairman, may bring out points of doubt or difference among the executive and, in the long run, contribute to more robust decision making.

It is important to recognise that non-executives are in the end dependent on what the executive disclose and bring to them to consider and what the executive disclose to internal and external auditors who will make their own reports to non-executives. But, the structure of the board can encourage good practice.

A.2.c Different roles for different non-executives?

The Association believes in unitary boards. There is danger in systematically allocating different roles to different independent non-executives. Complacency can arise if people think that someone else is “responsible” for a particular matter. So, for example, in principal, any independent non-executive should be able to sit on or chair any sub-committee, for example remuneration, appointments or audit. **All independent non-executive directors should be entitled to attend any meeting of any committee, even if they are not actually a member of it.**

So, the Chairman (and Deputy Chairman or other designated senior independent non-executive, see issue 7) apart, we would not advocate different roles for different non-executives. (See also comments on qualities and attributes needed for non-executive directors.)

That said, **we do recognise that there needs to be a useful balance of skills and experience among the independent non-executive directors.** We discuss this further in comments on required skills, knowledge and experience in response to issue 9.

A.3 Roles: Comparison with the present position

Our normative comments on roles, above, do in general correspond to the present practice. The main differences are

- **some Chairmen are not independent non-executive directors**
- **some companies combine the roles of Chairman and Chief Executive in one person**

- **too few companies’ boards include a simple majority of independent non-executive directors**
- **There are no doubt also boards where independent non-executives do not collectively bring an appropriate mix of skills, knowledge and experience, and**
- boards are sometimes inadequately conscious of their moral accountability to the wider public (with which they may have dealings or to whom they may incur liabilities) in view of the company’s use of the privilege of limited liability

We suggest how these could be tackled elsewhere in these comments.

A.4 Non-executive directors – how independent

A.4.a.1

Ideally, the more independent independent non-executives are, the better. However, there is only a finite pool of persons available for non-executive positions – although The Association makes comments below on expanding the pool (issue 13).

The Association supports the concepts of independence used in the Combined Code which is the original Cadbury guidance requiring that non-executive directors “be free from any business or other relationship which could materially interfere with the exercise of their independent judgement”^{3,4} but going further in requiring that they be “independent of management”⁵.

We find the ABI/NAPF expanded criteria for independence⁶ helpful. We suggest some areas of enhancement elsewhere.

We comment on issues of conflicts of interest affecting all directors in issue A.5.a.

There are three issues affecting non-executives on which particular comment should be made.

A.4.a.2 Independence: Financial interests

A.4.a.2.i Independence: Interests in shares, options or performance related remuneration

Ownership of shares in a company usefully aligns independent directors’ interests with shareholders at large. If that shareholding is a material portion of the individual’s wealth, conflicts may arise, for example relating to an intention, even

³ Cadbury Report, para 4.12

⁴ Persons associated with suppliers should clearly not be regarded as independent. This point has not been accepted sufficiently widely and bankers particularly seem to feel themselves to be exempted.

⁵ Combined Code, provision A.3.2

⁶ Responsible Voting, 1999, ABI/NAPF

vague, to make a sizable disposal at a particular time, which mean the director would no longer be independent in the sense intended⁷.

Furthermore, **The Association notes that issuing directors with options or schemes which vest shares or grant shares or material bonuses dependent upon company reported performance and/or share price, can destroy their independence. This is because of the conditional, or leveraged nature of these interests.**

The concern is that the non-executives lose detachment. For example, with conditional vesting or award of shares, achievement or not of the condition – earnings being at least a certain figure in a particular year or the share price being at least a certain level on a particular date – is crucial to the value. With options, small variations in share price can make a very large difference to the value of options. Executive director remuneration may have similar features. These factors can affect consideration of when to take actions which may have short-term negative earnings impacts or require announcements which may adversely affect the share price or may put achievement of targets at risk, even though all are in the long-term interests of shareholder value.

However part payment of director's fees in shares, not with conditional vesting but subject to a requirement that they must be held until three years after leaving the Board may achieve the desired alignment of interests without creating loss of independence⁸.

A.4.a.2.ii Independence: Interests in pensions and other deferred remuneration from the company

A person having been a member of management and becoming a non-executive director of the same company is unlikely to be seen as potentially an independent non-executive director. Acceptable independence may become possible after a (long) minimum period of time between cessation of management responsibilities and appointment as a non-executive.

However, **former employees in receipt of, or potentially in receipt of, deferred remuneration from the company (especially where this is linked in some way to company performance) or benefiting from pensions, other than defined contribution pensions, supported by the company clearly cannot be regarded as “independent” non-executive directors.**

The pensions issue arises because defined benefit schemes create exposures for the company and interests for pensioners. The conflicts can be seen for example in:

- questions about the company's funding a big pension scheme deficit or taking a contribution holiday if there is a big surplus

⁷ We believe that the restrictions on time of dealing in relevant securities by directors are appropriate and we would be concerned if European regulations now in contemplation were implemented in such a way as to weaken or remove these restrictions.

⁸ The non-executive should also agree not to use derivatives related to the company's shares during this period, or the effects of the requirement to hold can be avoided. Directors are of course prohibited from using derivatives while directors.

- consideration of disposals or closures or acquisitions or expansions which change the number of active members of such a scheme in relation to the number of pensioners or deferred pensioners
- evaluating changing the risk in the business (by commercial or investment activity or by strategy change or by change of gearing or other financial risk policies) which would alter the chances that the company would be around in the future to "bail" out the scheme or improve pension terms in relation to inflation.

A.4.a.3 Independence: Cross executive/non-executive directorships

There is, in practice, only a relatively small pool of people perceived as potential candidates for major plc boards as non-executives, many of these commonly being executives in other plcs.

Thus there is a suspicion, particularly in matters of executive remuneration, of mutual back-scratching.

Indeed there would still be public scepticism about remuneration awards if non-executive directors included any persons who were in full time employment elsewhere - the "old boy network" would still be seen to be, or suspected of being, alive and well.

There seems to be little that can effectively be done about this in the near term, although some suggestions are made in response to issue 13 below and it is important that action is taken to improve the longer term position.

The more immediate solution to the usual mutual back-scratching complaint lies in the hands of the institutions, who could take a more active role in censoring - and trying to organise more successful opposition to - greedy or self-serving deals.

A.4.a.4 Independence: Time served

It is difficult for non-executives to keep their independence from executive directors with whom they work and whom they learn to trust over a period of many years. On the other hand, it is not possible to make maximum contribution without time to become more familiar with the business, operations and environment. Industry cycles vary from activity to activity and economic cycles are relatively long.

The ABI/NAPF statement⁴ regards periods of more than 9 years as too long. We have sympathy with this but an arbitrary limit is too inflexible.

A balance is needed and **a board collectively needs to determine appropriate policy for how long its non-executives should serve. It should publicly disclose that policy.**

A.5 Conflicts of interest

A.5.a Interest conflicts in dealings with third parties

Conflicts of interest for all directors arising from company dealings or potential dealings with parties with which the director is associated are familiar. All directors need to be alert for possible conflicts in this area and to have in mind not only regulatory requirements for disclosure but the practical need to remind

colleagues when relevant issues arise. As well as regulatory requirements in this area there is also a duty on directors in view of the fiduciary nature of their office.

A.5.b Conflicts of interest of executive directors and their staffs

A.5.b.1 Defending one's own turf

Executives responsible for developing strategies and bringing forward significant proposals will inevitably feel some commitment to them and thus be constrained in properly evaluating comments received from others.

A.5.b.2 Not inviting criticism of one's own subsequent proposals

Executive directors responsible for other areas may feel constrained in evaluating and criticising things put forward by peers with whom they have to work on a day to day basis and whose support they may need for their own proposals. In any case, most significant proposals will already have been discussed (and agreed) by an executive committee or by the executive directors informally. Debate at board level will be constrained by these factors.

A.5.b.3 Rose tinted spectacles

And, of course, executives responsible for, and for reporting on, a particular activity may be tempted to put as good a face on things as they can. Executive colleagues may withhold criticism in evaluating those reports because their own area may one day have its own difficulties. Similar concerns arise regarding reports on the company as a whole.

A.5.b.4 Anything to do with remuneration and benefits

The executives' remuneration schemes and benefits, including pensions, their position as employees and their day to day involvement in company affairs with its opportunity for enrichment give potentially many conflicts of interest. Once granted, some benefits, such as share schemes or benefits conditional on performance, give rise to other potential conflicts. This is because executives can be influenced in their decision making and reporting by forthcoming opportunities to cash in benefits under share schemes or measure achievements under conditional schemes. (C.f. comments on non-executive compensation in issues A.4.a.2.1 and A.4.a.2.2, above.)

A.5.b.5 Executives in membership of defined benefit pension schemes

Non-executives need to be aware that executives may belong to defined benefit pension schemes which put in them similar conflicts to potential non-executives who are have pensions or deferred pensions from such schemes – see comments on issue A.4.a.2.ii, above.

A.5.b.6 Takeovers and management buyouts

Takeovers and, particularly, management buyouts, are another area for potential conflicts of interests. For example there is the prospect of cashing in of share options at the bid price, the impact on deferred remuneration schemes or pension schemes, or, perhaps, because of either tacit understandings about future

management positions or, conversely, fears of being dismissed. In buyouts, members of the buy-out group have a direct clash of interests with shareholders.

A.5.b.7 Looking after one's people

Close involvement by executives with their staffs will lead to trust. While no doubt generally aware of the issue, executives may in evaluating proposals or reports from their staffs be less aware of potential conflicts of interest in their staff akin to those set out above.

A.5.b.8 Executive ego-trips

Matters may be brought forward for the board's approval which are more to do with executive prestige than shareholder value. They often represent a disproportionate investment of management time for small and uncertain reward. Examples could be found among: new headquarters; new, single, state of the art manufacturing facilities or warehouses; acquisitions, especially cross-border acquisitions; establishment of complex financing structures.

A.5.c *Non-executives' role in protecting against conflicts of interest*

Good executives will manage all these conflicts honourably and well. But non-executives have an important role in helping them in this area which is crucial in maintaining good corporate governance.

The cool head and *independence*, willingness to speak up, persistence and robustness of the non-executive director are all vital qualities in protecting against conflicts of interest.

Regarding executive remuneration and benefits, some commentators have advocated requiring new executive director contracts - or material amendments thereto - to be conditional on approval by, or to be ratified within a given period by, a shareholders' resolution. The remuneration committee – which should be composed entirely of independent non-executive directors – would have to justify their decision to the shareholders, including institutions which may take an interest and ask questions, as may the press. This, it is argued, would help the committee and the other non-executives to think hard about the terms they would confer on the executive. The counter-argument is that it may genuinely be difficult to get the right person for the job if he/she is subject to approval in this way. Profoundly sceptical of this counter-argument, **The Association supports the right of shareholders to vote on remuneration packages of executive directors.**

A.5.d *Help for non-executive directors regarding conflicts of interest*

A.5.d.1 Access to professional advice

The potential of interest conflicts can be a most complex area and **non-executives may need access to financial, legal, or actuarial advice or to other external experts, for example in the field of executive remuneration, if they are to form a useful view of any particular situation or proposal.**

A.5.d.2 Communication channel

While some conflicts of interest may be apparent from understanding of proposals or reports, some may not. **No director is in a position to catch well-planned fraud by company insiders. Non-executive directors need all the help they can get in this area and company insiders who have worries or suspicions are crucial here.**

It is significant that some of the issues which resulted in corporate scandals in the UK prior to the Cadbury Committee were known among the financial community in London but concerned senior corporate finance and treasury executives in the companies, who are part of that community, had no channel to express concern within their companies.

Discussing the current round of corporate scandals in the United States, John Hunt has wondered in the *Financial Times*⁹ that "... whole departments of

⁹ John W. Hunt, emeritus professor of organisational behaviour at London Business School, *Financial Times* August 16th 2002.

professionals must have colluded in silence.... How is it that honest, dedicated employees accept such practices?"

Some companies believe it helpful to have set up a mechanism for staff with concerns in this area to report those concerns through secure channels. In the US, the Sarbanes Oxley Act seems to require a "whistle-blowing" mechanism as part of the company's formal structures.

As regards such concerns at Board level, a secure channel for professional staff below the board, or even executive directors, to be able to express any concerns to non-executives generally, possibly via the Chairman or chairman of the audit committee is important. This is especially true for staff below board level where their own functional or line executive director or the company secretary are involved.

Employed professionals must be helped to give precedence to "You are either honest and professional, or you are not" over "You are one of the team or you are not". (See also Section III para v., above))

In passing, it may be noted that external service suppliers, banks etc., who should have been well aware that something odd was going on in the UK cases referred to above also took no action to raise the matters with appropriate independent non-executives at the companies, although they did gossip about it to other clients.

The Economist of June 13th comments on the recent US scandals thus:

One of the more interesting features of the assorted revelations now scandalising the market is that many of them are hardly news. Everybody suspected that America's energy-trading companies inflated their revenues. Software-contract accounting was an acknowledged black art. And the fact that telecoms firms bought from each other to boost their numbers has shocked nobody but neophytes. The big institutions knew who the cheats were. But life was good, and they nodded and winked and chose to go along with it."

A.6 Time commitments of non-executives

A.6.a.1 No hard and fast rule

The time needed for non-executive directors to be effective varies enormously from company to company. The maturity, complexity, scope and geographical spread of a company's activities and the rates of change of important factors in the environments in which it operates are key and highly variable factors.

A.6.a.2 Site visits

Non-executives need to devote time to site visits – sometimes overseas in the case of multinationals – and to familiarising themselves to a sufficient level with the industry/ies involved and its/their environments¹⁰. Visits will often have been organised as part of an overall board programme or an induction programme for

¹⁰ Pricewaterhouse-Coopers already report that their own research indicates that "best practice is for NEDs to spend time with management and employees on the ground". *Sounding Board* Issue 11, July 2002, PricewaterhouseCoopers, page 4

new directors. They have the advantage of the opportunity to meet management and staff below board level (but see issue D.25.b, below).

In making all such visits it is essential that the Chairman and the relevant executive director are aware of the visit and its purpose, and that any report arising from the visit is to the Chairman and copied to the relevant executive director. No element of “going behind management’s back” or “encouraging staff to betray confidences” must be allowed to dominate the attitude to a site visit. Rather, a spirit of open enquiry is essential.

A.6.a.3 Papers and other material; briefings

Non-executives need to devote time to studying papers or other material (see below) related to board meetings and committees which they can attend.

They need to allow time for extra briefing etc. where there are important matters for discussion which are outside their experience or education or previous briefing. For example the non-executives need, when the board is considering strategy, to ensure that they have a grasp of the strategic options, the risks and the dependencies. This is time consuming.

At certain times of major corporate events, acquisitions and disposals, take-overs, industry crises or consideration of major changes of strategy for example, much greater demand on time of non-executives will be made.

A board Chairman or the chairman of a board committee will need to devote extra time to these roles and to the additional briefing needed.

A.6.a.4 Need to limit overall commitments

It will be clear that no general prescription of the amount of time a non-executive needs to devote is possible.

A Chairman’s role would probably demand 2 to 3 full days a week in normal times and more at others. That implies that **it would be difficult for a Chairman to Chair more than one other unrelated company or, alternatively, to have more than a couple of non-executive posts on boards of non-related companies. The ABI/NAPF code should be adapted accordingly.**

In general, responsible non-executives must limit the extent of their non-executive positions in the light of their other commitments. Someone in substantially full-time employment, for example a practising lawyer or a senior executive of another company, has very limited capacity to take on even one non-executive directorship¹¹. This could usefully be addressed by the ABI/NAPF code. Many UK plcs limit executive directors (and senior executives below the board) to a maximum of one or, much less often, two, non-executive directorships of unrelated companies.

A person with a great deal of time available can take on more.

It is noteworthy that the code proposed by the government appointed commission in Germany in February 2002 has recommended that no member of a management board should sit on more than five supervisory boards of unrelated

¹¹ The cooperation of their employer/partners would be needed even to do one properly.

companies. This seems a very high limit for a full time executive and probably illustrates the different role of “non-executives” in that country.

In the UK the NAPF’s recommendations are that directors should limit themselves to five positions, including boards of not-for-profit bodies. This seems generous.

The Association does not believe that regulation is required to limit directors’ commitments. It is best left to the individual, to the good sense of boards in appointing non-executives and to pressures from investors, including through the ABI/NAPF code, and to external commentators who are today more alert to the issues.

A.7 A “Senior” independent non-executive?

The Association advocates that the Chairman should be an independent non-executive director. Combined Code provision A.2.1 calls for a recognised senior non-executive other than the Chairman. This would, we believe, be the person for the other non-executive directors to turn to if the Chairman is away or, more importantly, be the focus of discussion if the Chairman is failing in his role, perhaps because he shows inadequate leadership or cannot get on with the chief executive – or gets on too well with the chief executive. This would be a valuable function.

The Deputy Chairman or the chairman of the audit committee are obvious persons for this role.

The Chairman, Deputy Chairman and chairman of the audit committee are also obvious persons with whom senior professionals in the company below the board should be able to raise in a secure manner matters relating to the propriety of actions or proposals by executive directors (see III.v and issue [A.5.d.2, above](#)).

It is desirable to identify a second senior independent non-executive (other than the Chairman). This would normally be the Deputy Chairman or chairman of the audit committee.

A.8 Proposed statutory statement of directors duties

A.8.a The General Principles

The proposed statutory statement is contained in clause 19 of, and Schedule 2 (General principles by which directors are bound) to, the draft Companies Bill set out in the White Paper.

The new statement of director’s duties is in principle a useful summarisation.

However, it is not a particularly easy read for someone not used to reading the language of legislation. Nonetheless, it should be welcomed as giving the company’s qualified company secretary or in-house lawyer hooks on which to base briefing of new directors, both executive and non-executive, rather than having to quote precedents and persuasive overseas rulings.

Attention to the drafting of Schedule 2 to make it more readable could make this a really useful and meaningful document, particularly for new directors.

The new statement sets out certain duties. To some extent they codify existing common law and in other respects the schedule sets out specific examples of what

would, in most circumstances, be commercial reality or common sense from the point of view of the company. We do have some concerns about the Schedule, which we explain below.

A.8.b “Success of the company” (paragraph 2(a) of Schedule 2 to the draft Companies Bill)

We believe that “success of the company” needs further qualification.

Importantly, the director is only required to “take into account” the “material factors”, so that it is clear that the “success of the company for the benefit of its members” is the overriding concern, other stakeholders’ interests being merely factors to be taken into account. (This is similar in emphasis to the existing duty in s.309 CA85 to “have regard to” the interests of employees.)

However, it would be of concern if the references to “the success of the company” could be construed as, for example, constraining the ability of the board to recommend a bid for the company that seemed to be good value for current shareholders and yet ran the risk of not promoting the long term interests of the company itself under its new ownership. Examples may be board being aware of an intention on the part of the prospective new owners to cannibalise parts of the company or even to transfer the whole of its assets and undertaking (for use elsewhere in the new owner’s group) and shut it down.

A.8.c Care, skill and diligence (paragraph 4 of Schedule 2 to the draft Companies Bill)

The wording of paragraph 4 of Schedule 2 talks about what “may reasonably be expected of a director in his position”. It is modelled closely on s.214, Insolvency Act 1986, which has been “adopted” by the courts as correctly stating the degree of knowledge, skill and experience required of a director generally, not just for the purposes of wrongful trading with which s.214 is concerned.

This means that, whilst there is no explicit distinction between executive and non-executive directors, the differences in their respective roles in relation to the company may properly lead to the conclusion that there are different levels of knowledge, skill and expertise that they should respectively have.

However, there are some drafting differences between Schedule 2, paragraph 4, and s.214 IA86 which give rise to concern.

A.8.c.i “in his position” (paragraph 4(a) of Schedule 2)

We would recommend the addition after “in his position” at the end of paragraph 4(a) of the words “in relation to the company”, to make it clear that the objective part of the test has to be looked at in the context of the director’s role in relation to the company itself, not more generally. If in fact the director happens to have other (general) knowledge, etc., it may be caught by 4(b), i.e. the subjective part of the test.

A.8.c.ii “additional knowledge,” etc. (paragraph 4(b) of Schedule 2)

In para 4(b), the use of the word “additional”, rather than “general” (see s.214), could catch specific matters known to the director which he is not at liberty to disclose to the company or its board, e.g. knowledge acquired by him in his capacity as a director of another company or as a former government minister or

civil servant. **We therefore recommend replacing in paragraph 4(b), “additional” by “general” (as in s.214IA 86) in paragraph 4(b).**

A.8.c.iii Fiduciary duties (re paragraph 3 of Schedule 2)

We are concerned by the note to paragraph 3 and its impact in respect of a director's fiduciary duties.

At present, the wording appearing in an irrevocable undertaking, in respect of the director's own holding of shares, to accept a takeover offer which is recommended by the board often tries to impose on the director, in his capacity as such, the obligation to continue to support the offer, notwithstanding a subsequent, more attractive bid. At present, it is recognised that such an obligation is overridden by the director's fiduciary duty to the company (even though the director, in his capacity as a shareholder, may continue to be bound by his undertaking to accept the first bidder's offer in respect of his own shares).

It is questionable whether the wording of the note to para 3 would continue to leave the director with that "out". The position could of course be made clear by appropriate drafting in the irrevocable undertaking, but this would become a bargaining point which the director might not be able to achieve.

Therefore, **it is desirable that some clarification to the note to paragraph 3 be made which recognises that the director's fiduciary duty overrides a conflicting contractual obligation binding on him personally.**

A.8.c Benefits from third parties (paragraph 7 of Schedule 2)

The Association, while supporting the principles, is concerned that drafting of paragraph 7 of Schedule 2 of the draft Bill is rather too restrictive.

The paragraph concerns acceptance by directors of "benefits" from third parties. It is drafted very broadly. Its effects need considerable narrowing to focus on the mischief at which it is aimed.

Consider an honour proposed for a director of a company limited by guarantee administering a charity or a professional body. The citation "for services to charity" or "the actuarial profession" may make the honour a "benefit conferred by way of reward for any exercise of his powers as director" and the Schedule may require the director to refuse the honour.

It is common for companies which are marketing products which are novel or complex to sponsor seminars, "teach-ins" or conferences on the subjects and invite company representatives, including directors, to attend free of charge. There may be meals provided, accommodation in the case of longer events or some kind of entertainment. At a smaller scale, many professional services firms, personnel agencies at all levels, accountancy and actuarial firms etc, will invite relevant staff of clients, including directors, to "business briefings" on a variety of subjects, perhaps over breakfast or lunch, as a way of keeping awareness of their firm high. Some aspects of the events may fall under paragraph 7 as worded, being not "necessarily incidental".

In practice, however, such sessions are cheap, easy and convenient ways of a company's staff, including directors, securing education and training as well as being networking opportunities.

As worded, the paragraph would probably also catch, for example, the acceptance by a director of entertainment offered to him because of his position with the company in question. In other words, it would be a breach of duty by the

director to accept an invitation to Twickenham by, say, investment banking advisers to the company, who have issued the invitation because of the director's position with the company, if the invitation has not been approved by a shareholders' resolution and is not "necessarily incidental to the proper performance of any of his functions as director", which it would not be.

These examples illustrate the difficulty that can be encountered when an attempt is made to codify in legislation a principle or rule that has existed in the common law, where common sense, applied to each individual case, dictates whether and how it is to be applied.

Most companies have rules on acceptance of benefits including gifts and entertainment. They usually include terms such as

- “approved in advance of acceptance by ...”
- “reasonable”,
- “if entertainment, of a level or value which the company itself would reciprocate”,
- “if goods, of a nominal value and with the name or logo of the company making the gift”
- “reasonably incidental to a business activity”
- (for employees, including executive directors) “unless for a business purpose, not involving absence during business hours, not taken as part of annual leave entitlement”,

Many companies also follow the good practice of requiring a register to be kept of all benefits received, which must regularly be appropriately reviewed. Review of registers is often part of the duties of the internal audit function as part of their visit to sites.

We suggest that if regulation is required on benefits from third parties, it be limited to requiring companies to adopt a code of practice to be followed by directors and to be made available by the company to shareholders or, in the case of public companies, to the public generally, on application if not permanently displayed, for example, on a company’s website.

IV. B: Attracting and appointing non-executives

B.9 Key skills, knowledge and experience required in non-executives

B.10 Personal qualities and attributes needed

B.11 Mix of experience and attributes

B.9/10/11.a

Some areas of experience and knowledge are required in all companies. Some knowledge of specialist areas is needed in some companies.

In considering these issues, we will deal with personal qualities (issue 10) first as these seem to be a fundamental necessity, but not always a sufficient requirement.

B.9/10/11.b Personal qualities

Many of the comments which follow apply as much to executive as to non-executives.

Non-executives need of course the basic business skills: they need to be literate and (adequately) numerate.

They are, ideally, what are sometimes called “T-shaped people” – people with a profound knowledge or expertise in their own area but with a wide interest across all aspects of business and some broad knowledge and experience. They must be able to balance different aspects of a problem.

They must be able to understand and distil the issues from reports and presentations – deconstructing them as necessary to understand what they are *really* saying. They need to recognise when the commentary on “rejected alternatives” in a proposal or strategy plan have been chosen to be unattractive, or were just too hard to evaluate, or meant “we did not do a proper job of evaluating this one” as either they worked so hard on the main proposal that there was not enough time or because the chief executive was prejudiced against it.

They need to be bright enough to be able, for example, to get quickly a grasp of the strategic options, the risks and the dependencies when reviewing strategic proposals from management.

Non-executives will not be working full-time with a company. Where the company is of any size or complexity or geographic spread there will be many issues coming up with which the director is unfamiliar or aspects of which have not come across before. Accordingly they need to be aware people who can grasp new things quickly and properly relate them to their existing body of knowledge.

They need a cool head and independence of mind, willingness to speak up, persistence and robustness. Shrewd, good judges of both people and commercial questions, they need discretion and an ability to keep silent where matters are for the executive and not the Board. They need common sense.

As their main communication with management will be in meetings, they need to be articulate and clear thinking good communicators. Their total opportunity for speaking as opposed to listening during board meetings or briefings will be very small and must be used effectively.

As communications speed up, as product life-cycles become shorter, as competition becomes more fleet footed, and as rapid change in political and economic environments becomes normal in more countries, directors need open-mindedness and flexibility of thinking.

A mix of leaders and shapers is needed.

It is relatively easy then to specify paragons. But without these qualities, the contribution of a non-executive director is likely to be small.

However, some of these personal qualities and attributes, judgment or reading reports for example, can be boosted or learned by support and training – when, perhaps, they could be regarded as skills.

B.9/10/11.c Skills/Technical knowledge/expertise

Then there is the question of technical expertise.

B.9/10/11.c.1 Dangers of experts

There is a danger, if a particular non-executive has a relevant technical expertise, that the other non-executives will rely too heavily on that non-executive and not think deeply enough themselves about the implications and risks of proposals involving that area. This is not an argument against experts. It highlights a requirement for a Chairman to ensure that this does not happen.

There is also a danger that non-executives will mistake or over generalize a colleague's expertise. Some examples illustrate what is meant:

- **A marketing man from the fast moving consumer goods sector may not have capital or defence goods marketing knowledge or skills**
- **A seller of corporate finance products – an investment banker – does not necessarily understand fully how or why those products are used by clients (companies, in this context)**
- **Accountants or people with other financial qualifications do not necessarily have any useful experience in corporate finance or financial risk management**
- **A European executive appointed to bring a non-Anglo-centric view, may know little of East Asia.**

Again, the Chairman must ensure that all the board members considers the implications and risks of proposals and do not abdicate in favour of “experts”.

Some experts can become obsessive about their area and concentrate on aspects relating to the area when debating questions where the issues fall in other areas. So, priority has to be given to the personal qualities in picking candidate “expert” non-executives.

B.9/10/11.c.2 The role of experts

We have commented earlier that independent non-executive directors should not provide *the* expertise on a particular subject to a company. Rather the expert non-executive director draws on his expertise and experience to help understand and evaluate the risks or opportunities in any particular proposal.

It is important to differentiate between a sufficient knowledge of an area and “expertise”.

Thus, it probably behoves non-executive directors of a regulated company to have a sufficient understanding of the regulatory framework of the business. Or directors of a company selling structured financial products to understand the principals of how they work and how the risks they create are managed. Insurance companies, for example, would fall into both categories.

It may be noted in any case that many “experts” who are in a position to be non-executive directors may not actually regard themselves as being at the leading edge in their field any more.

B.9/10/11.c.3 What experts for most companies?

There are some areas for which non-executive experience/expertise is an advantage for most companies of any size or complexity. But these are very few. It is always open to the board to ask for advice from external (or internal) experts if they are not happy they have a sufficient understanding.

It is important to note that many companies take pains to expose their senior executives to the key functions in the company. Thus the major fast moving consumer goods companies include a level of marketing in management development programmes for all. This level is probably sufficient for them to understand (perhaps after a few questions) well presented marketing proposals or proposals which will affect the company’s market position. The same applies to many other functional areas. Most MBAs too cover a wide field as well as allowing particular study of certain areas.

Thus most potential non-executives will have some understanding of business processes in general.

The company secretary will be present at board meetings and, certainly for companies of any size, will be qualified¹² and so a source of general corporate regulatory and legal advice. In the largest companies, a separate legal director will be present.

So, if management cannot explain a proposal to a lay board, there is a strong argument for saying that the latter should be wary of the proposal. The danger is that management will explain the advantages of the proposal and how it would work, without going into the disadvantages and how it might not work or what risks or unintended consequences need thinking about. That is where the importance of the personal qualities discussed above can be seen, in that non-executives should be able to draw out these points even in areas in which they are not experts – provided that the chairing of the meeting is appropriate.

Non-expert directors, even Chairmen, are sometimes known to be impatient and find boring the questioning of matters by directors with expertise, experience or professional qualification in particular areas. This is folly. It may be that some matters can be better followed up outside a particular board meeting, but it behoves other directors at least to receive a report back on the matter and understand why there was an issue.

¹² See comment under issue 26.a.3

One specialist area where businessmen in general (including many accountants) will have little background is in corporate finance and corporate financial risk management. Given that the cause of many corporate scandals or collapses lies in these areas, perhaps that is one expertise which should be present somewhere among the non-executives. Certainly non-executives should interest themselves in the qualifications and standing of senior executives below board level responsible for these areas.

B.9/10/11.c.4 Experts for specific companies

This is a question of balance. The answer probably depends on the nature of the business.

On the other hand, if the very nature of the business is complex or technical, to an extent that, without a full understanding of the complexities and technical aspects, the non-executive directors cannot properly assess the risks (e.g. an investment bank which undertakes complex market transactions), then there will obviously need to be that expertise among the non-executives. Indeed, any person taking up the position of non-executive director of such a company without some degree of knowledge of the area would presumably feel uncomfortable at his lack of understanding of the issues that would need to be discussed from time to time at board meetings.

This is not to say, however, that *every* board member must have relevant technical expertise. Indeed, if all the non-executives were experts in the technical aspects of the business, they would normally be unlikely to have sufficient appreciation of the other aspects.

There are probably numerous cases of individual non-executive directors who do not fully understand some of the important risks affecting their companies, and who therefore may not know how to monitor those risks and who rely on other non-executive directors who do have the relevant expertise. This reliance should be based on regular and probing questioning, and not blind faith.

B.9/10/11.d Experience

This is a most important area of “qualification” of non-executive directors.

Few people would advocate an immediate non-executive directorship for even the top-graduate of an MBA programme who had started it straight after school, university and two years of back-packing abroad.

Experience in the relevant industry concerned may be valuable. But such people are probably present among the executive directors. Experience in different or related industries is perhaps more valuable.

While experience of other board-type positions is also important, this does not necessarily need to be on other top company boards. Experience on divisional or subsidiary company boards or policy making groups in large, multinational companies, or involvement with boards of not-for-profit organisations – indeed anywhere where collective agreement and responsibility is necessary – is valuable too (see issue B.13, below).

We refer extensively in this submission to the importance of the assessment of risk overall and individual types and sources of risk and of considering how/if it is to be managed, as forming a key part of the role of the non-

executive director. We go on to make the observation under E.28/29.b.2 that risk assessment and management is the area where most directors have the least experience but are expected to contribute the most. We note that individuals who have held the overall treasury role at a senior level (which posts usually have responsibility for other functions — corporate finance, tax, insurance, commonly) are likely to have had to assess financial risks — at the project, subsidiary and overall group level, as well as risks in the techniques and instruments they use to manage such risks.

In order to do their job properly, they will have had to get a good understanding of the business generally and its sources of risk and opportunity. We regard such experience during their careers, with responsibility taken for the management of financial risk within a company, and the meshing of these risks with the overall risk profile of the company, as being an essential part of the background of any finance director. The Association considers that the understanding of risk held by good treasurers, with an appropriate academic or professional educational background to ensure its generalisability, should be seen as a key element in the experience profile established for a proportion of non-executive directors.

The key element is the presence of experience of how success depends on activity integration, cross-functionally, how failure can result from unintended consequences as well as from bad planning per se, and how people can make good plans go astray or bad plans work tolerably well.

B.9/10/11.e Skills, qualities, experience: summary

The Association believes that the personal qualities of candidates are the key and generally more important than particular expertise.

It does not believe that regulatory or code specifications in this area are helpful. Discussion of the kind made above can help focus minds when it comes to non-executive appointments, but this is not an area where prescription is appropriate.

B.12 Recruiting non-executive directors

Companies do not find recruiting non-executive directors with the right qualities to be easy.

Use of a nomination committee is a useful way of preventing non-executive directorships being in the personal gift of Chairmen, or CEOs – a useful check and balance and an important part of overall internal control. It is not a mechanism for easing recruitment, however.

These difficulties are not the product of the recruitment mechanisms as such. They arise because recruiters are defining too narrowly the pool of candidates in which they search. The key influence in this often seems to be the recruitment consultant used, the companies often expressing themselves more open to look more widely.

This attitude of recruitment consultants is a defensive reaction, minimising their risk, permitting them simply to consult their existing list of names without doing or buying further research and, as a happy consequence, making their services all the more necessary in view of the difficulty in recruitment it engenders.

Recruitment consultants in turn blame institutional investors who, they say, look for people they are familiar with and mistrust new faces.

While admitting that they do indeed find it reassuring to see a non-executive they are comfortable with on a company's board, the institutional investors say they would positively welcome some new faces of appropriate quality – and indeed urge it, so as to widen the pool. **Regular public comment from institutional investors or the bodies representing classes of them about the need to recruit more widely is probably the fastest way to free up the situation and extend the search for good potential independent non-executive directors.**

B.13 Widening the pool of potential non-executive directors

B.13.a. The pool

B.13.a.1 Sources of independent non-executive directors

At present, the search for new non-executive directors tends to be conducted among executive directors and those who are already non-executive directors.

Executive directors of other companies are often reluctant to devote the extra time necessary to sit on audit or other committees of boards on which they are non-executives. This is often the case for other persons in full time employment. While the retired or those pursuing “portfolio” careers have more time, it is desirable that each board committee has some current business experience.

As noted above (issue B.9/10/11.d), anywhere where collective agreement and responsibility is necessary, at the appropriate level, can be a suitable background environment for new non-executives.

Divisional or large subsidiary company boards or the policy making groups of particular functions in large multinational companies, or the boards of not-for-profit organisations are useful areas for prospecting, even for the smaller FTSE 100 companies.

Selective recruitment from academia, the civil service and among senior professionals would usefully expand the pool, although some extra induction or orientation training may be necessary in order that they make their contribution more quickly¹³.

Institutional investors admit a significant bias to look for proven commercial experience, but will accept that that is to overlook the benefits of adding other experience.

Companies, and particularly the recruitment consultants advising them, need to think more openly on this. The consultants need to improve their research and stop sheltering behind “the institutional investors”. Only in this way will they stop perpetuating what Paul Myners, author of the government sponsored report on the pension industry, called “the self-perpetuating oligarchy”.

The pool will not widen sufficiently, however, without satisfaction of other conditions - see for example “insurance provision” below.

¹³ Indeed the Combined Code requires that all directors receive appropriate training on first appointment (provision A.1.6)

B.13.a.2 Stakeholders

There is some discussion of seeking to include “stakeholders” (employees, customers, etc.) in the pool.

Directors should have regard to the interests of the company (no doubt taking account of the interests of particular stakeholders) and not to the interests of those interests groups they “represent”. Whilst that is the fiduciary duty, directors are only human and, if they see themselves being appointed to the board because of their position in some relevant interest group, they will inevitably tend to push that group’s interests rather than the company’s. **Thus, it is undesirable to have directors appointed because of a particular position or connection.**

The whole point of non-executives is to bring a broad, balanced judgement and single issue advocates need to be avoided.

Of course, individuals who have pursued a career in stakeholder issues may have an excellent background, personal qualities and skill set. While some FMCG companies, for example, have appointed consumer activists as non-executives, scope for this seems limited except on the largest boards. The amounts of education and training needed in many cases would be impractical.

B.13.b International representation

The need to attend in-depth briefing and availability to attend meetings at short notice (which accompany times of significant corporate action such as takeovers and mergers) is difficult for non-residents to fulfil. Furthermore, the business culture which has given rise to the UK system of corporate governance, with unitary boards which meet frequently and include *independent* non-executives, is largely confined to the major Commonwealth countries. This can be a difficulty for non-resident people from other backgrounds.

That said, the different experience and knowledge of a non-UK national can be very important for companies with a material proportion of their business outside the UK. Many companies have non-UK national executive directors, of course.

Thus the Association’s view is that greater international representation on UK boards is a marginal contributor to widening the pool of potential non-executives.

There are other ways of bringing in non-UK nationals. We would urge more experiment with, for example, outside international advisory appointments to multinationals’ strategy planning advisory groups. Eventually, experience of individuals in this sort of context may open up more possibilities of appointments to non-executive directorships.

B.14 Rewards for non-executives

B.14.a Total rewards

There are some key factors here.

Non-executives need to be rewarded for several things:

- Their time
- Their wisdom and experience
- The reputational and financial risks they run.

These will vary from case to case. Some companies demand more time from non-executives than others. During certain periods, a company demands more time than at others. The quality of the inputs made by the non-executives surely varies too.

Non-executive directors who take their duties seriously often seem not to be adequately rewarded. This may be a contributory factor towards the over-full portfolios of appointments of some people.

It may also be a factor in recruitment difficulties for some companies, although the major factor seems to be mind-set (see issues.12 and 13 above).

However, concern would arise if a single non-executive directorship were a major part of the income of the individual. The independence of the non-executive is partly dependent on their willingness to walk away in case of significant disagreement or concern.

B.14.b Form of remuneration

Difficulties arise when “independent” non-executives are offered share options or shares with conditional vesting arrangements or rewards (bonuses, for example) conditional on company or share-price performance.

If such forms of remuneration are at all material, they undermine the independence of non-executives (see issue 4.a.2, above). The non-executives are placed in the position of benefiting from, for example, a particular year’s performance or average share price. Rose tinted presentation of the year’s expectations and, eventually, results may then benefit non-executives as well as employees. The non-executives’ roles as checks and balances are weakened.

Such reward schemes may have their place for non-executives in start-ups or in other companies with a small, involved group of shareholders – start-ups that have progressed to angel or venture capital stage I or II funding. But they are very difficult to put into a public company context.

We noted above that part payment in shares, subject to conditions on disposal, can foster alignment of interests with shareholders generally (issue 4, above). Our earlier comments also call into question the independence of a non-executive director a significant part of whose wealth is tied up in shares of the company.

B. 15 Risks and insurance provision

The significant risks involved in being a non-executive director are a factor in the minds of potential candidates. Indeed, if someone is not concerned about the risks, they probably are not a suitable candidate – part of the role being to have in mind the risk in the company’s business, strategy, etc.

The greatest risk for a non-executive director, assuming he has acted in good faith and with reasonable diligence, is to be caught up in litigation. Defence costs alone, unless fully indemnified by the company, could be crippling – even the preparatory costs in cases which never come to trial. In addition, there can be serious “wear and tear” on an individual, as well as a large time commitment and the risk of loss of reputation, in the event of his being caught up in legal proceedings. The risk is there, even where there is no suggestion of fraud (e.g. Equitable Life).

It would not be sensible to make taking on non-executive directorships even less attractive for people in or nearing retirement, as a consequence of setting higher standards and duties for non-executives. This would inevitably reduce the pool of those willing to take on such a role. Furthermore, given the inability, in practice, of non-executive directors to unearth misdoings by management, if the latter are intent on pulling the wool over the non-executives' eyes, it would be quite unfair on the latter for the law to be changed to increase their liability.

Of course, indemnification from the company is only of limited value if the company gets into financial difficulty and may only be available where the director is exonerated at the conclusion of legal proceedings.

The general practice is also to include non-executive directors in the company's "Directors and Officers" policy. D&O insurance, at the company's expense, is essential as part of the package.

D&O cover and indemnification must continue after a non-executive's appointment is over and, in respect of prior periods, after the company lapses its D&O policy. If there are technical difficulties, whether corporate or tax, with such insurance or with companies providing indemnification as part of non-executives' contracts with the companies, they must be eliminated¹⁴.

Non-executives also need to be able to procure their own insurance¹⁵ as top-up cover above the D&O cover referred to above and for credit risk against the company in respect of liabilities under contracts of indemnity.

Without a substantial level of such protection, an individual would be unwise to accept appointment. Attention to the issue is growing, particularly with recent major increases in D&O policy costs. Adequacy of cover, where it is provided, is a concern.

There is a useful analogy in the growth of liability limitation in professional practices. Most major accountancy firms now have used some mechanism to achieve this.

For non-executive directors, the problem is having shelter while convincing shareholders of their necessary involvement. **Much further study is needed of the possibilities of limiting personal liabilities to realistic levels.**

¹⁴ Suggestions that D&O cover should be treated as a taxable benefit are extraordinarily mis-judged. D&O cover is equivalent to a radiographers' radiation monitoring badge.

¹⁵ Such cover has been available, for example from the Institute of Directors, but the issue is usually the amount of cover.

IV. C: Structures and accountability

C.16 Working of the combined code

C.16.a.1 Working?

It is in the nature of the stipulations that it is very difficult to tell if the combined code is working well. For example, the provision, A.4.1 that the Chairman should ensure that all directors are properly briefed on issues arising at board meetings could, in most cases, only be assessed in current protagonists' memoirs, with the benefit of knowledge of what happened in the intervening years.

However, in general it seems to be working and working better as people become more accustomed to it.

C.16.a.2 Future of the code

The Financial Reporting Council is a convenient, but not necessarily an ideal, custodian of the Combined Code.

Although we generally favour the development of codes such as the ABI/NAPF's, we are concerned that parties to any future development of the Combined Code be widely drawn.

C.16.b Chairman and Chief Executive

The Association does not believe that the Code provision, A.2.1, allowing companies to justify publicly the combination of the posts of Chairman and chief executive in one person is helpful and would rather see it deleted. It would be replaced with wording stating that principle 2, calling for a clear division of responsibilities between the key tasks of running the board and running the company's business, such that no one individual has unfettered powers of decision, requires that different people carry out the two tasks. This could be just a recommendation for un-listed and un-quoted companies.

C.16.c Board balance

C.16.c.1 Number of (independent) non-executives

As argued above, The Association would advocate that independent non-executive directors, including the Chairman, comprise a majority of the board. Code provision A.3.1 would be re-written accordingly and A.3.2 would comprise simply the definition of independent non-executive director.

C.16.c.2 Independence

We would not expand the definition of independence in the Combined Code, believing that investor pressure such as the ABI/NAPF 1999 statement "Responsible Voting" is a better way of achieving this, although we have above suggested small modifications to the AIB/NAPF expanded requirements for independence. (See issue 4)

C.17 Board Committee structure and Board meeting procedures

C.17.a Board committees generally

We have noted above the difficulty of getting full time employees of other companies to attend committee meetings of boards on which they are non-executive directors. This is a major constraint on the creation and operation of board committees generally.

Board committee meetings tend to be rather brief, and sensible discussion or debate is rarely possible. On the other hand, papers submitted are allowed to be longer and fuller than main board papers. They are still much briefer than the papers submitted to the committees of executive directors and their staffs which consider similar matters internally. It does seem that the committees are often seen as a way to reduce the pressure on the agenda of board meetings by curtailing the time spent on committee issues there, rather than as being a way of increasing the contribution of non-executives.

That said, committees do in principle give the non-executives a greater opportunity to consider committee issues, and some of them make use of this.

The Association would urge that the Combined Code stipulations for non-executive director membership of specified board committees be changed to specify independent non-executive directors.

C.17.b Board meeting procedures

The Association has no comments on this subject.

C.17.c Board size

The size of a board needs to vary according to the company circumstances.

The board needs to be of sufficient size to provide a critical mass of independent non-executive directors.

Too small a board does not get a sufficiently broad range of skills and experience around the table. Too large a board limits the contribution any individual can make.

For public companies of any size, a holding company board of 9 to 13¹⁶ may be suitable. Fewer and the company's executive committee, consisting of the executive directors and a few others, can begin to make the structure look like the German model. More, and it begins to look like a town meeting.

C.18 Composition and duties of Audit Committees

C.18.a Audit Committee effectiveness

Within the constraints on operation of board committees generally, referred to above, Audit Committees seem to be working well, with two areas of concern:

¹⁶ 9: Chairman plus four other independent non-executives plus four executives; 13: add two independent non-executives and two executives.

- **Some Audit Committees seem to be too passive in their interpretation of their roles**
- **Not all Audit Committees have the correct relationship with the Internal Audit function.** (See issue 18.b, below.)

Shareholder comment is probably the most effective way of dealing with the first issue.

The audit committee should be comprised entirely of independent non-executive directors. It needs access to good advice from within the company and without.

C.18.b Audit Committees and Internal Audit

The Combined Code under Principle D.2, Internal Control, says (provision D.2.2) that companies which do not have an internal audit function should from time to time review the need for one.

However, under principle D.3, Audit Committee and Auditors, which considers among other things the application of internal control principles, the provisions make no reference to the internal audit function.

We regard the head of internal audit as having one of the potentially more difficult but important jobs to do. If internal audit work throws up suspicion of any senior executive or executive director, the head of internal audit, who is often lower in grading than other heads of function below board level, can have a difficult path to tread.

We consider that the Combined Code would be strengthened if the Audit Committees duties (provision D.3.2) were extended to include keeping under review the work of the internal audit function. Such wording would also imply, in case of need, a direct link between the Head of Internal Audit and the Audit Committee and, thus, its chairman.

As well as review of the work of the internal audit function, the Audit Committee also would naturally wish to see that there is a good and fruitful relationship between internal and external auditors

External auditors' work in relation to major corporate clients tends to concentrate on testing principles and systems, with much less testing of specific transactions. Internal auditors, who undertake rather different kinds of work, are thus usually better placed to detect problems of fraud, false accounting or failure to comply with company policies, etc., than external auditors.

It is also appropriate that the Audit Committee – or the remuneration committee – may also take an interest in the remuneration and benefits of the head of internal audit, to reduce the potential for undue influence. Similarly, any proposed dismissal of the Head of Internal Audit, or their movement to another post in the company should be considered by the Audit Committee.

C.19 Nomination and Remuneration Committees

We have no general comments on this issue, except that we believe the committees should be comprised of independent non-executives director and that they should have access to expert advice from within the company and without.

However, we believe that the overall remuneration and benefits of the Company Secretary should be approved by the remuneration committee (see issue 26.a.3, below). The same applies for the Head of Internal Audit if such oversight is not exercised by the Audit Committee (see issue 18.b, above.)

C.20 Objectives and performance review for the board as a whole and for non-executives

C.20.a Objectives and performance review for the board

While the board as a whole can set targets, such as completing a regular strategic review by such and such a date, that can simply mean that the review is not presented to the board in appropriate format or adequate detail or with sufficient opportunity for debate. Measuring “performance” for a board would be very difficult. Consultancies operating in this area, for example ICSA Board Performance Evaluation Service, tend to focus on structure and information flow – ie things supporting potential performance, rather than out-turn performance.

It is however a useful arrangement for the board to have an “away day” every couple of years, with a good process consultant, to discuss and review “how well it is doing” in terms of the adequacy of briefing, the quality of proposal papers, the conduct of and participation in debate, etc. This is a very hard thing for boards to do – hardest perhaps for the executive directors. The outcome of consultant reviews like BPES (above) can be discussed at such meetings.

C.20.b Objectives and performance review for non-executive directors

The setting of objectives and review of performance of executive directors as executives should be part of the normal, formal, senior executive arrangements of the company.

No analogous arrangements are useful for non-executive directors. As for the board overall, measuring “performance” by non-executives is very difficult. Is attendance more important than substantive contribution (perhaps outside board meetings, by discussion with the Chairman)?

However, it is useful for the Chairman to feed back his comments to non-executives - see our comments on issue 30, below.

C.21 Reviewing board performance; reporting to shareholders

This smacks of box-ticking and runs the risk of introducing into the board proceedings a backside-covering mentality, with formalistic proceedings replacing free-ranging discussion, so that “performance” returns can be made to shareholders. It is not credible that a Chairman will comment publicly to shareholders that non-executive director Bloggs comes to meetings ill prepared and leaves early having had only a tentative grasp on what was going on.

C.22 Ability of non-executive directors to challenge executive decisions or expose serious problems

C.22.a Ability

Experience varies enormously from board to board.

Influence is most difficult when specific developed proposals are brought to the board. By questioning, non-executives can cause executives to take proposals away for further work and bringing back to later meetings, but if the executive come back with unchanged proposals, in practice they pretty well have to be accepted.

Similarly, by questioning as part of the monitoring activity, non-executives can cause executives to re-visit issues which can reveal problems, but this would be unusual as executive directors and their staffs have much greater information which should throw up problems long before they become apparent in board level reports. If non-executives do cause problems to be picked up in this way, the problem they are really identifying is complacency or dereliction among the executive.

Non-executives' contribution is greater when, for example, major strategic reviews are underway and the board has a series of presentations during the process.

The non-executives must be able to understand the proposals made and the background information. This goes back to the skills issue discussed above.

It also depends on the information that comes from management. See comments under Exposure of serious problems, below (C.22.b.2).

C.22.b Mechanisms

C.22.b.1 Presentation of proposals

In the majority of companies, proposals are generally brought to the board as single point solutions, evaluated on a single set of assumptions. Perhaps some "sensitivities" are evaluated, but risks and contingencies and inter-dependencies are often not fully exposed. In relevant cases, the place of the proposal in the company's portfolio of activities is often not discussed in the proposals.

It is in this area of risks and the overall portfolio that non-executives should be making their major contribution.

Similar comments may be made about strategy developments, annual budgets, etc. Too many boards receive, for example, an evaluated single strategic plan on a take it or leave it basis.

Non-executives can help themselves by insisting that the ways in which proposals are presented be more appropriate and looking for greater professionalism from the executives and their staffs. It is very worrying that pressure on companies from non-executives is most often to reduce the volume of information they are given rather than to improve its quality and relevancy.

We have discussed under issues B.9/10/11.b the skills needed to read proposals.

There is also the problem of the time needed to assimilate, integrate and reflect on information presented. This is not only a question of the devotion of non-executive time *per se*, but also of the period over which matters can be thought about. For major proposals, strategic plans, etc. it is not reasonable to present information at or for one meeting. It is better to allow consideration at two, or more. This undoubtedly means exposing non-executives to the executives' thinking at earlier stages and probably before alternatives have been rejected. The meeting time for consideration of the final proposal can thereby be greatly reduced.

Companies can assist by ensuring that non-executive directors have available equipment to be able to receive documents etc. electronically and are able to view presentations at their own convenience prior to meetings. It is reasonable to expect the discipline from non-executives actually to look at and listen to this material – one person who has not bothered can slow down a meeting unacceptably. Using modern media for this, it is possible to provide, for example, hyperlinks to other presentations or background material – both company generated and that available from other resources including other websites, even those of competitors, suppliers or customers. These links can be followed by non-executives less familiar with an area and be passed over by others.

C.22.b.2 Exposure of serious problems

This depends on the information that comes from executive management. Their good faith is crucial. The degree of information *routinely* provided is therefore important, as it should be designed to expose to the board as a whole the main risk areas. Obviously, if there is fraud or concealment, the non-executives may be positively misled. But it is much easier to mislead the non-executives by failing to provide full routine or ad hoc information than by trying to doctor routine information which, if properly provided, is designed to deal with the main risks. **No change in the law or best practice procedures will overcome the fraud or concealment risk.**

Once again, the non-executives, once provided with the information, must be able to understand it, which calls into question the skills issue discussed under issues B.9/10/11, above. And non-executives need to devote the time to studying and understanding the information (see issue 6, above).

IV. D: Relationships with shareholders and others

D.23 Relationships between non-executives and shareholders and stakeholders

D.23.a Relationships with shareholders/institutional shareholders

One problem we are very conscious of is the need to strike the right balance between getting close to institutions and yet not giving them price-sensitive or company confidential information. Share options, as “relevant securities” have greatly tightened the criteria here. With quoted options, for example, a material change in price can arise from matters which would give only a small change in the share price itself, so much greater caution is needed today than before options were commonplace.

Flow of information to the market, including institutions, will normally be as a controlled process involving the Chairman, the Chief Executive, the Director of Finance and certain of their key staffs and bringing in others only under especial circumstances and in a controlled environment. This is commercial prudence as well as being necessitated by the Financial Services and Markets Act.

Thus, it should be very surprising if much of the flow was from the non-executives to the institutions. Rather, non-executives should be sensitive to the concerns of institutions about more global affairs, which they can take into account in considering the business of the company, probing more deeply in areas of concern.

On the other hand, institutions can find informal meetings with non-executives (and executive directors too) valuable in building confidence in a company’s governance and strategy – non-operational matters. Occasional opportunities can be made to do this.

If an institution has issues about a particular company, then their approach would normally be through the Chairman, not other non-executives. Only if the institutions were unhappy about the Chairman would they talk to other non-executives, usually the senior non-executive other than the Chairman.

D.23.b Relationships with other stakeholders

We would expect the company’s relations with other stakeholders to be conducted through the executive directors and their staffs. Under some circumstances it may be desirable for the Chairman to accompany the Chief Executive, or others. If a particular non-executive has a particular relationship with a particular stakeholder, the company may wish to take advantage of this. For example a former diplomat may know the president of a country where the company is considering starting operations. There is a danger that this starts to affect the independence of the non-executive director.

In general, we see no role for non-executives in relationships with other stakeholders.

See also comments above on stakeholders as non-executive directors, issue B.13.a.2.

D.24 Are Chairmen creating conditions for non-executive effectiveness?

Chairmen certainly should be promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows. The Chairman should be a leader. A proper leader would seek to do all of these things; others may not. Legislating for them, whether in a code of best practice or otherwise would be no guarantee of performance.

Good leaders would also keep themselves up to date on how best to promote all of these good things and in this limited respect lesser mortals can be helped by advisory codes prompting them.

In practice, the picture appears to vary enormously from company to company, as may be expected.

It is necessary, of course, to be selective about the amounts and types of information, the subject areas covered and the amount of background information provided. When things do go wrong, they are often to do with aspects of the business it had not been felt worthwhile covering in board reporting. Board information is often not fit for purpose, representing a jungle of data accumulated over the years, difficult to navigate through and including matter in forms not accessible to non-experts.

Unfortunately, a key concern of many Chairmen appears to be one of reducing the amount of information flowing to non-executives rather than one of maximising its value.

Using modern media, different levels of information can be made available to non-executives according to how each perceives their own needs. (See comments in response to issue 22 above). There is, however, often great hostility to the use of modern media for communication between the company and the non-executives. Put unkindly, "If board papers cannot be read in the back of the car on the way up to town, they are too long, and you can't expect people of our generation to use computers." We hope that passage of time will eliminate this attitude.

D.25 Relationships of non-executive directors with other directors, senior management and key advisers

D.25.a Relationships between non-executives and executive directors

The relationship between non-executive directors and executive directors should be one of independence. Whilst relations can be friendly, and indeed it is valuable for them to be so, they nevertheless need to be at arm's length.

Non-executives should normally deal with executives through the Chairman. And vice-versa. Arranged thus, contact with executive directors outside the formality of the board room can help build confidence.

The chairman of a board committee would normally be directly in touch with the relevant director, for example the audit committee chairman with the finance director.

It is very important to avoid factionalism on a board.

D.25.b Relationship between non-executive directors and senior management

Generally, there should be no relationship between a non-executive and a non-director member of management at any level.

Exceptions would include

- the company secretary (see issue D.26., below)
- a direct line of communication between any of (i) the treasurer, the financial controller, the internal auditor and the in-house lawyer/head of compliance and (ii) the chairman of the audit committee (or the Chairman) in case any of these persons was concerned about the acts or attitude of the finance director
- the opportunity for the audit committee to meet the head of internal audit without the presence of other employees at the time of their meeting with the external audit partner at the review of interim results and the audit of annual results
- a secure channel for employees generally to express concerns about conflicts of interest or questionable actions among senior executives or executive directors (see comments under issue 5, above).

That said, the opportunity for non-executive directors to visit company operations or to attend company conferences and incidentally meet senior executives or other employees is valuable. And they will meet senior executives who are making presentations to the board and may thus incidentally attend board lunches etc. In some cases, senior executives may be invited to board lunches as a way of mutual exposure.

Furthermore, it is useful for non-executive directors to be able to arrange through the Chairman and via the Chief Executive to be briefed on matters in the purview of staff at senior executive level about relevant matters.

This can all lead to mutual confidence building as well as giving the non-executives a better understanding of the business. But none of it should be seen as constituting a relationship except in a trivial sense of the word.

D.25.c Relationship between non-executive directors and the Chairman

This has been explored above, (see issues A.1.b, D.24, E.30)

D.25.d Relationship between non-executive directors and the Chief Executive

The relationship with the Chief Executive should be similar to that with other executive directors. The exception is that non-executives under the Chairman's leadership may have to act to dismiss the Chief Executive. Similar dissatisfaction with other executive directors is more likely to be resolved indirectly through discussion, via the Chairman, with the Chief Executive.

D.25.e Relationship between non-executive directors and key advisers to the company

D.25.e.1 Advisers: general

The Combined Code already provides that the non-executive directors should have access to advisers at the company's expense. This is slightly different from

whether they should have access to the regular advisers, who would normally deal only with management.

The answer must be that any director must be free to question, through management, and probably via the Chairman (certainly with his knowledge), the company's advisers on a matter on which they are advising the company.

There are certain important cases where non-executives should be wary of advisers.

For example, the Chairman would expect to be able to receive the advice of the company's broker and principal merchant banking adviser on matters relating to the company's listing, share actions, takeovers etc. Normally he would do this with the Finance Director and Chief Executive. The broker and merchant bank may also be involved in other activity with the company and it is important clearly to segregate that from the foregoing.

It is not unknown for investment banks to abuse their link to the Chairman to seek to promote their other business, lobbying directly, for example, for advisory appointments regarding acquisitions, or for lead management positions in bond issues or syndications. The Chairman should not undermine the company's banking relationship strategy by allowing this lobbying.

D.25.e.2 Advisers: remuneration committee

The remuneration committee would expect to be able to consult appropriate advisers on remunerations schemes, both as regards director remuneration, schemes for senior executives and any schemes involving company securities or options. They would expect to do this through management, except possibly in regard to director compensation.

D.25.e.3 Advisers: audit committee

The audit committee would expect to be able to consult the relevant partner of the external auditors. Normally they would do this through management but in case of need they should do it without the presence of management and in any case should meet the audit partner without management after the auditor's review of interim results and after the audit of annual results.

D.26 How can company secretaries support effective performance by non-executive directors

D.26.a Relationships with the Company Secretary

D.26.a.1 Relationships of independent non-executive directors with the Company Secretary

We have commented above that the Company Secretary should be available to all non-executive directors as a channel of communication with the company.

It is important that the non-executive directors view the Company Secretary as "friendly" and confidential, as he can act as a bridge (particularly in the provision of information) between the non-executives and the management.

D.26.a.2 Relationship of the Chairman with the Company Secretary

The relationship between Secretary and Chairman is also important. There should be mutual trust, so that the Chairman can confide in the Secretary on matters which he may not wish to discuss with the chief executive or other members of management. The Company Secretary should be able to influence the Chairman as to what constitutes proper information for and briefing to the board and can be influential in adoption of modern media in this context (see issues C.22.b.1 and D.24 above).

D.26.a.3 The good Secretary

The Secretary will be more useful to the Chairman and the board if they cultivate good collegiate relationships with the Treasurer (and the Corporate Finance head if that is separate) and internal legal adviser (if that is not the Secretary himself) who will all be concerned with good corporate governance and communications with the market and be the functions behind many technical board resolutions.

The Secretary should also be professionally qualified and a current practising member of an appropriate professional body. Company Secretaries must be much more than competent administrators¹⁷.

For the Secretary to be able to carry out his responsibilities to the board, various conditions are necessary. The Secretary may have other duties in the company than those as Company Secretary, and in respect of those duties he would normally report to the appropriate executive director, but as Secretary he should report to the Chairman as being responsible to the board as a whole.

While the Combined Code states that “any question of removal of the company secretary should be a matter for the board as a whole”, it is also appropriate that their salary, benefits and other terms and conditions be approved by the remuneration committee of the board to avoid possible undue influence or conflict of interest.

¹⁷ In passing The Association should record its concern at current Government proposals to abolish the requirement for some companies to appoint a company secretary.

IV E: Support for non-executive directors

E.27 Access to information; communication channels

We have already commented on this under various issues above.

We discuss information available to non-executive directors under issue 24, above.

Where important matters are due for discussion which are outwith their experience, non-executive directors can reasonably expect to ask for additional briefing – either from relevant professionals working for the company or from external advisers. They need to allow time for this.

We have already commented under issues 22.b.1 and 24 on the desirability of companies ensuring that non-executives are equipped to use modern means of communication and to be able to access additional background or briefing material (company and external data) where they feel it is necessary.

Non-executives should also expect availability of external advice (as well as advice from relevant professionals within the company) regarding matters which are the responsibility of particular board committees, for example the audit committee. (See issue D.25.e.2 and D.25.e.3, above)

E.28 Training and development opportunities for non-executive directors

E.29 Can induction for non-executive directors be improved?

E.28/29.a Induction

E.28/29.a.1 General induction

Companies should allow some budget for initial training for new directors in accordance with the Combined Code, and also for later development activities.

The programmes for new directors run by the Institute of Directors can be found useful, but some major companies have their own programmes which can be more focused.

However general training - about the role and duties, etc. of non-executive directors is likely to be most helpful for persons looking to become non-executive directors of smaller companies. This is because it seems unlikely that a large company will be seeking to appoint someone who does not already have a considerable experience of boardrooms, including the non-executive director's role there, so that any idea of mandatory training of this type would seem over-the-top.

It would, however, be helpful for best practice to include the provision to all new directors of a memorandum describing the duties, etc of non-executive directors - as some companies do now.

E.28/29.a.2 Company specific induction

It is valuable for directors new to any company to follow an induction programme about the company's structure (organisational and financial), strategy (including briefing on principal competitors), principal businesses and areas of operation and any framework of regulation etc. affecting the business or its conduct. The key internal and external risks factors affecting the business should be discussed.

They should also be furnished with relevant policies of the company and have an opportunity to discuss them with the relevant executive director or the senior executive below the board if there are technical issues underlying the policies. They should be briefed on the principal advisers to the company.

An opportunity to "walk through" the regular Board reporting pack, the regular strategy planning and monitoring processes and similar matter with appropriate executive directors or their direct reports, is important. This should include discussion of the current strategy monitoring documents.

Too few companies undertake all this in a systematic manner. Discovering these things as you go along is wholly inappropriate.

The experience of members of The Association in the strategy, corporate finance, treasury and risk management areas of corporate decision making is that such help for non-executives can be very valuable. It can help them make a contribution, and to make it earlier – which is important in view of the ABI/NAPF guideline that they should normally serve a maximum of three 3-year terms if they are to be regarded as independent. It can avoid non-executives' not engaging quickly enough.

A balance is of course needed: too much training could flood non-executives with too much detail and be counter-productive to the arm's length, strategic position that independent non-executives should take. But most companies do not even begin to get in sight of this danger.

Best practice guidance on company specific induction would be useful to companies.

E.28/29.b Subsequent training and development

E.28/29.b.1 General

We noted under issue 11 (above) that some aspects of personal qualities, judgement, for example, can be boosted by support and training, and can to some extent be regarded as skills. A good Chairman should suggest useful courses or advice sources to non-executives as appropriate.

E.28/29.b.2 Concepts of risk

We would observe that the area where most directors, executive as well as non-executive, have least experience is in an area where they are generally expected to contribute most, both as delegated monitors of the shareholders and as advisers to management. That is in risk assessment and management – overall, not just financial risk management, which is itself important. Directors often lack even the vocabulary necessary to begin to consider these issues. Where companies have got into major difficulties it is often because of a failure at executive or general board level to consider what strategies or other important decisions are doing to aspects of risk and how the interactions and dependencies are affecting

aggregate risk in the business. Training of an appropriate nature in this area would probably do more to prevent corporate collapse than any other support to non-executives. It is an area which some executive directors and many professional staff below board level find frustrating as many boards refuse to consider the topic at all.

Exposure to such training would help avoid non-executive directors blindly relying on the executive and their staffs or on the involvement in proposals of a known external service provider – for example from the financial area, an investment bank, accounting or actuarial firm. There are elements of such types of pusillanimity to be found in most corporate finance scandals in companies and the current round of examples in the United States appears to be no exception.

See also issue B.9/10/11.d

E.30 Non-executive directors: guidance on expectations; feedback on performance

Only few companies give formal guidance on expectations of a new or prospective non-executive director. Feedback on performance is usually only received (from the Chairman) when explicitly sought and then normally given in vague terms.

Good leaders give clear guidance on expectations and regular feedback. Good Chairmen do it too, including advice on suitable training opportunities or the need to visit parts of the company or get briefing from in-house or external experts on aspects of the company's business. .

All Chairmen can learn to do it and inclusion of passing references to the need in commentaries etc. can stimulate them to try. Advice is surely available from any number of external personnel development consultants, if the Chairman feels constrained from using the company's internal training programme for new managers.

IV. F: Smaller listed companies

F.31 Different factors? Different provision?

F.31.a General

The Association's members are in the main involved in large listed company affairs and the comments on issues reflect this.

We do believe that the principles observed in our comments should apply to all public companies.

There are some areas where smaller companies may have disproportionately greater difficulties in observance. We highlight two, below.

F.31.b Directors as experts

It would be understandable if smaller listed companies, lacking the numbers of employed professionals which a larger company would have, turned to non-executives with a particular expertise as its adviser on that that subject, as noted by the Hampel Review. We repeat, however, our doubts about such a director who is the only or the authoritative source to the company of that expertise counting as an *independent* director in looking at the composition of the board unless the matter is not very important or the advice is incidental.

F.31.c Internal audit

Small companies may not be large enough to support a viable internal audit function. The brief of external auditors can be extended to make up for this to some extent.

IV G: International context

G.32 What international lessons about behaviour or structures?

G.32.a

The Association is generally very open to international experience and practice.

The comments below are the result of reflection not insularity.

We believe that the UK system of corporate governance, with unitary boards, which meet frequently and include *independent* non-executives, is inherently potentially superior to other models.

G.32.b *Avoid US practice*

The Association deprecates the US model of both structure and behaviour.

The concept of “independent” non-executive directors as accepted under UK practice appears foreign to US experience. The practice of non-executives (“outside directors”) being appointed by the CEO who, if he does not himself chair the board, appoints the Chairman, renders almost meaningless the monitoring and accountability roles of the board.

Flooding the board with non-independent US-style non-executives may be more than merely pointless, making proper discussion of issues impossible while engendering a dangerous sense of safety in numbers.

The surprise of US businessmen at the involvement of non-executives on the better UK company boards is almost as great as their surprise at the paucity of general external advice available to UK companies compared to that available to US companies of similar size and smaller by way of “International Advisory Boards” etc.

G.32.c *Avoid European practice*

As noted variously above, The Association believes in unitary boards. The nature of the contribution of supervisory board members to European companies is different in many respects from that required in the UK structure.

The statutory inclusion of stakeholders makes supervisory boards more of a talking shop and less able to take an objective view. (See B.13.a.2, above.) Their normal inability to meet at short notice or as frequently as UK boards is a great handicap.

The absence of a significant number of company executives on supervisory boards makes supervisory boards too remote. The absence of more than one or two supervisory board members on management boards makes the latter like second rate versions of the executive committees commonly found in UK companies.

Observance of the shock to European businessmen appointed to UK company boards is salutary to observe. Such people have much to contribute, but not in the field of governance structures and behaviour.

G.33 Do other governance models etc. contribute more to company performance?

G.34 Would it be beneficial to align UK practice more with that in other countries?

It is important to recognise, as stated in several places above, that good people can make even a bad model work after a fashion, or even quite well.

The Association is not aware of any studies of the principal Western economies which are helpful on this subject, satisfactorily separating the other important factors on company and total economy performance, notably factors affecting competition. There are, on the other hand, many discussions of the theoretical aspects of the various models.

In view of this and the potential frictional costs of moving to other models, **we would answer these questions with a clear “no”.**

Academia, as source of non-executive directors	Issue B.13.a.1
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The Association of Corporate Treasurers
Ocean House
Little Trinity Lane
London, EC4V 2DJ

Telephone: 020 7213 9728, fax. 020 7248 2591

E-mail: enquiries@treasurers.co.uk

Contact points re these comments

Richard Raeburn, Chief Executive: e-mail: rraeburn@treasurers.co.uk

John Grout, author of these comments: e-mail: johngroutx@aol.com