



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

***Response from the Local Authority Pension Fund Forum***

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### **1. Introduction**

1.1 The Local Authority Pension Fund Forum brings together 25 public sector pension funds with combined assets in excess of £40 billion. The Forum's mission statement is to 'promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest, commensurate with statutory regulations.'

1.2 With this focus, the Forum takes a close interest in the ongoing debates over improving corporate governance among listed companies. The Forum welcomes the enquiry being undertaken by Derek Higgs. This is both timely and necessary given the concerns expressed over the functioning of boards of directors both the UK and the USA.

### **2. Role of non-executives**

2.1 Our views on the role and number of non-executives at listed companies were set out in our submissions to the Company Law Review. The Forum broadly supports the current governance framework of non-executive and executive directors sitting on unitary board. However, we have concerns over non-executives' current ability to perform the roles expected of them. These concerns centre on their independence, their background, their numbers, their calibre and the support they can draw upon.

2.2 While we share the view that all directors have fiduciary responsibilities in respect of the company, we consider that non-executives are in a separate position to that of executive directors and that they perform different roles. These different roles should be recognised in law with a specific definition of their status. We do not see the additional clarification of the roles of non-executives as at odds with the draft statement of directors' duties set out by the Company Law Review, which we support.

2.3 Their two main roles are to advise and supervise the executive management. They should see themselves as having a special duty of acting on behalf of outside shareholders and other stakeholders particularly where executive directors may face a conflict of interest over issues such as takeovers, remuneration, accounting policies and board succession. At present, we do not consider that non-executives are either willing or able to perform these roles effectively in many cases, though we recognise there is a mixed picture.

2.4 In order to be able to hold executive directors accountable, we think that there should be a majority of non-executives on the boards of large listed companies.

2.5 Among these, we support there being a majority of independent directors, with the definition of independence being set out in a code of best practice rather than leaving it to the self-assessment of boards. We do not think that boards currently take a rigorous view of assessing their own independence, as is required by the Combined Code. Boards of smaller and family-dominated companies, and investment trusts, are particularly poor at identifying independence issues. There should be full reporting of directors' biographies including identification of any family relationships and reference to any age limitations for board membership.

2.6 Any definition of independence must deal with the issue of length of board service. As the Cadbury Committee recognised, there is a real danger that after a period, a director's ability to act independently is reduced.

2.7 We recognise that some of the advisory functions for non-executives can be performed by directors who are not independent (eg by former executive directors). However, the supervisory functions can only be fulfilled by truly independent directors who face no real or perceived conflicts of interest.

2.8 We are concerned by the multiplicity of positions that many non-executives hold. This can only lead to a situation where they are 'spread too thinly'. Various views have been expressed on the maximum number of non-executive positions that may be held. We consider it is important that boards should provide assurance to shareholders that a non-executive has adequate time available in cases where they have multiple other positions. Better biographical reporting including all other major positions would go some way to improving shareholders' ability to assess whether non-executives are too stretched.

### **3. Attracting and appointing non-executives**

3.1 We are concerned by the narrow pool of people from which non-executives are drawn. This both offends principles of equality of opportunity and also limits the experience and knowledge on which boards can draw. Expanding the pool of non-executives was mentioned by the Hampel Committee, but little progress has been made.

3.2 The main reason for this seems to be the insistence that non-executives must have senior business experience. We agree that this is a vital area of knowledge for many, but not for all. Other forms of senior experience within other types of organisation may well be valuable and would broaden the perspective of boards. Any particular deficiencies in knowledge could be rectified through specific training.

3.3 The most important skills required are common sense, integrity, and independence of mind and robustness of character. These are by no means confined to senior business people. Indeed, functions akin to that of a non-executive and requiring the same basic skills, are fulfilled by many people in other types of organisation, including in the public and voluntary sectors.

3.4 At present, we are not convinced that nomination committees function effectively. There is little information about how they operate, and most include at least one executive director. We would support a requirement that nomination committees are composed only of independent members, though, of course, for executive appointments, they would work closely with the chief executive. Nomination committees should also approach their role more professionally, learning lessons from human resource practices. They should draw up a person specification based on the board's requirements. Posts should be advertised rather than relying only on headhunters, a company's professional advisers or other directors' own personal contacts.

3.5 When candidates are put to the vote at AGMs, the reasons for their nomination should be argued on their merits, rather than it being assumed that a board recommendation will go through on the nod. New directors should be able to justify what additional skills and experience they will bring to the board.

#### **4. Structures and accountability**

4.1 As mentioned above we would support a Combined Code requirement that a majority of directors should be non-executive, and a clear definition of independence. However, this should not preclude shareholders and others taking their own views of independence issues. We consider that all board committees dealing with supervisory issues, should include only independent directors. Also each board committee should report annually to shareholders on their activities in terms of how often they met, who attended, the broad issues discussed and any major outcomes.

4.2 Board performance review mechanisms currently are lacking in most companies, or at least, they are seriously under-reported. It is very important that boards start to develop procedures for assessing their performance both collectively and individually. The outline of these mechanisms should be reported to shareholders in terms of how the review is conducted, by whom, what it covers and any major remedial actions taken. Until shareholders can be confident that boards are appraising their own performance, they will continue to have doubts over the contributions made by directors. As such, director appraisal is of vital importance for enhancing confidence in the effectiveness of boards. It is also important to justify any increases in non-executives' fees.

## **5. Relationships with shareholders and others**

5.1 LAPFF regularly meets companies to discuss governance and corporate responsibility issues. At no time has a non-executive (other than a non-executive chairman) been present. This is testament to their lack of activity in the area currently. We would value the attendance of non-executives at such meetings. Indeed on some issues it would be more appropriate to meet a non-executive than an executive. We think that the opportunities for formal meetings between the non-executives alone and shareholders should be explored.

5.2 The role of the chairman is crucial for facilitating such discussions. The primary role should be in ensuring that the board functions effectively and provides leadership. This is incompatible with having an executive function. We therefore support the legal or regulatory separation of the roles of chairman and chief executive for large listed companies.

## **6. Support**

6.1 There is a clear danger that boards will receive only the information that executive management want them to receive. It is part of the chairman's role to ensure that boards are receiving wide range of opinions. It is part of the non-executive's roles to scrutinise the information and recommendations they are receiving from management. In order to do this, it may be necessary for non-executives to take a second and independent opinion. There should be allocated expenditure to enable the non-executives to do this if they feel it necessary.

6.2 Our experience is that reporting on training and induction is sporadic to say the least. As with any other senior position, there should be structured and ongoing training opportunities and an expectation that these will be taken up. There are general training needs for all directors in terms of their common functions, but also specific training requirements for non-executives. Boards should set aside a training budget.

## **7. Smaller listed companies**

7.1 LAPFF does not consider that separate provisions are necessary other than as set out above.

## **8. International context**

8.1 We recognise that different corporate governance structures are the product of a complex interaction of cultural, legal, corporate and capital market

structures. These have resulted in a multiplicity of different outcomes. In recent years, there has been some move to harmonise structures around a an 'Anglo-Saxon' model. However, recent market events and scandals demonstrate that no model is perfect. While we support the current basic UK governance form, this should not preclude consideration of other models drawn either from overseas or other forms of organisation. The most important considerations should be that any form of governance structure is transparent, allocates clear responsibilities, and ensures accountability.