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Financial Reporting Council Review of the Effectiveness of the Combined Code

Recommendations from Tomorrow's Company

Summary

Our two main recommendations are to reword and extend the Combined Code so that

- it truly encompasses the responsibilities of investors alongside those of boards
- it better reflects cultures, values and behaviours in the assessment of risk and allocation of rewards

Recommendation one: Responsibilities of Investors

Section D1 of the code speaks of the responsibility of the board to have "satisfactory" dialogue with shareholders based on "the mutual understanding of objectives". There is no equivalent statement to suggest that shareholders have an equal responsibility for ensuring that satisfactory dialogue takes place.

This section of the code needs to be rephrased in the spirit of stewardship as a joint obligation. Investors who do not comply with the code should explain why they choose not to engage in accordance with its provisions.

The code also singles out dialogue with "major shareholders". Without compromising the requirement to treat shareholders equally with access to information, more latitude should be allowed for the company to concentrate its communication efforts on "more engaged shareholders" who reciprocate in this dialogue.

The Code should also state an obligation for institutional shareholders to define to what extent, if any, they intend to exercise stewardship, and publish the stewardship principles to which they expect to work, and then communicate regularly with the beneficial owners on their adherence to these principles.

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Recommendation two: Culture, Values, Behaviours and Remuneration

The other major changes suggested spring from the need for a more extensive and rigorous approach to the definition, assessment and management of risk, especially around culture, values and behaviours. A number of changes to the wording of the code are suggested of which the most important is the addition in the Main Principle at the start of the code of a responsibility of the board not simply to set but also to uphold the values of the company, and the inclusion of "appropriate behaviours" to the framework of prudent and effective controls. This also leads to changes in the treatment of remuneration – especially the time horizons for rewarding performance, and an obligation for boards to explain the rationale behind their pay arrangements and ranges from highest to lowest. We also see the commitment to the professional development of board members as being an important lever for underpinning these changes in the longer term and have restated our 2002 recommendations with regards to Chartered Director status.

Further recommendations on risk and innovation will follow the completion of a current BERR/Tomorrow's Company study on the subject of Innovation, Risk and Governance.

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Introduction

In response to the March 2009 call for evidence, we have been examining the Combined Code from two perspectives – stewardship and innovation.

Our research, conducted with BERR on "Tomorrow's Innovation, Risk and Governance" will be presented separately to the FRC.

Our current submission draws from the wider work of Tomorrow's Company over 15 years, (summarised in the box below) but also from the research, dialogues and development work that we have been doing as part of our programme "Tomorrow's Owners – stewardship of Tomorrow's Company".

The FRC have, in particular, asked for evidence on the following items of content of the code:

The composition and effectiveness of the board as a whole

1. *Roles of Chairman, executive leadership and NEDs*
2. *Board's role in risk management*
3. *Role of remuneration committee*
4. *Quality of support and information available to the board*
5. *The content and effectiveness of Section 2 of the Code which is addressed to institutional shareholders and encourages them to enter into dialogue with companies based on mutual understanding and make considered use of their votes*

And the following items on its application.

6. *Comply or explain*

The recommendations arising from our ongoing and as yet unpublished research on Innovation, conducted with BERR, focus particularly on the items 1, 2 and 4, and will be presented separately.

The recommendations from our research on stewardship, which is presented below, focus particularly on items 2, 3, 5 and 6. Consequential drafting revisions to the 2008 Code are then supplied as Appendix One.

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The dynamics of responsible Capitalism

Over the last 15 years Tomorrow's Company has championed the idea of responsible capitalism. At various times we have described what this means for companies, for their investors, and for governments and wider society. Our work has evolved from research, dialogue and problem-solving with leaders of business and investment. The key principles can be simply summarised:

- The future success of companies lies in the quality of their leadership and the health of their relationships, and it is on these elements that sound governance and reporting should focus alongside the immediate financials (an inclusive approach);
- Leadership and governance at its best is a virtuous circle* which starts with the setting of clear purpose and values, and goes on through defining how success will be achieved and the key relationships by which it will be achieved to the development of measurement and reporting frameworks to enable outside investors and stakeholders to judge progress;
- In the light of the growing importance of global environmental, social and governance issues, business can and must be a force for good. While every business will make its own decision as to its purpose, we see the purpose of tomorrow's global company as being "To provide ever better goods and services in a way that is profitable, ethical and respects the environment, individuals and the communities in which it operates."
- Global business needs clear frameworks to align its operation with the needs of society and environment; corporate governance codes form a vital element in the emergence of these frameworks.
- The role of government is to create a climate and a framework in which companies are free to compete and innovate and are rewarded for operating responsibly, but constrained by law from operating in ways which steal from future generations in order to enrich the present;
- Governments can minimise the complexity and scope of business regulation by imposing the highest standards of transparency and self regulation;
- A healthy business climate in turn will be strengthened by an investment system in which investment performance is pursued over the long term by a focus on good business standards; business is conducted transparently in order to promote trust and confidence; and investment customers and beneficiaries are offered clear choices and have access to the necessary information to be able to make those choices. The setting of the right standards is a leadership obligation for those who head up major financial services companies and those who control access through professional qualifications. The largest institutional shareholders should consider working together to support directors of the companies in which they invest in making decisions in the long term interests of investors.
- Shareholders have various roles, but their most important (and currently neglected) role, jointly with directors, is to act as stewards in a process through which they influence and directors lead companies in the direction of long-term, sustainable performance that derives from contributing to human progress and the well-being of the environment and society;
- In the UK's unitary board system this stewardship responsibility extends equally to all directors, whether executive or non-executive, and all need to be prepared and trained separately and professionally for their board role.

* See Appendix Three for an explanation of the virtuous circle of governance and leadership.

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The basis of our recommendations

The Combined Code on Corporate Governance sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders.

Tomorrow's Company has been involved in the dialogue about the Combined Code from its origins in the Cadbury Report on the financial aspects of corporate governance. We made a submission to the Higgs Review of the role of non-executive directors and we will be referring here to some of the recommendations we made in 2002 – particularly those which relate to the need for boards over time to become professionally qualified - which, we believe, have become even more necessary in view of recent failures. The summary of our 2002 evidence is attached as Appendix One.

Many of the issues raised in this submission emerged for our 2004 inquiry *Restoring Trust – investment in the twenty-first Century*, chaired by Sir Richard Sykes with participation from major listed companies and major investors, as well the London Stock Exchange, the Department of Trade and Industry and HM Treasury. The report from this inquiry offers a "helicopter view" of the system, and 5 agendas for change covering:

- The need for clear enforceable standards and principles;
- Alignment and transparency throughout the investment value chain;
- The exercise of ownership rights and responsibilities;
- Evaluating long term business success;
- The individual investor.

The two main recommendations in this document relate to the need to extend the Combined Code so that it starts to define the joint stewardship obligations of boards and shareholders and the need to reflect cultures, values and behaviours in the assessment of risk.

The importance of stewardship

Stewardship is the process through which investors influence and directors lead companies in the direction of long-term, sustainable performance that derives from contributing to human progress and the well-being of the environment and society. Following recent failures in the financial sector, there is growing concern about "ownerless corporations"

"The focus of an 'owner', with an emphasis on creating long-term value, does not sit comfortably with the commercial pressures on an 'investor' obliged to produce short-term returns. Institutional investors are expected to exert the influence and exhibit the values of 'owners' but are incentivised to behave as 'investors', with performance scrutinised on a quarterly, monthly or even a daily basis…
To put it simply: most institutions are not set up to act as owners; they don't have the mindset of owners and are not incentivised by their clients to act as owners. They are investors-leaseholders rather than freeholders. (…) The picture I paint is one that has led us in the direction of what I have characterised as 'the ownerless corporation', reflected in fragmented share registers and inconsistent investor engagement. The true owners, for instance pension fund trustees, have been intermediated out of the story."
Lord Myners speech to IMA Annual Dinner 19 May 2009

As savers and individual investors, we need to be served by an effective group of institutional investors whose priorities and behaviours are aligned with the long-term interests of the company in which they are invested, and who are concerned to improve rather than undermine the health of the soil in which investee companies are nourished. We need boards and institutional investors who exhibit a broader and deeper understanding of the ingredients of success, and who have the tools of analysis by which they can advance this understanding. This has always been true, but it is even more important now that we know that companies are operating in a business environment in which risk and opportunity are driven so much by environmental and social issues as much as economic ones – what we call the triple context.

As with most complex problems of this century, the key to the better governance of companies does not solely lie with any one group. The Combined Code represents an important piece in the whole jigsaw of the kind of good governance of our companies that we will need, and it needs to pass the test of promoting good stewardship.

After numerous dialogues with over 70 directors, investors rulemakers and policymakers over the past year we have defined stewardship as

"the active and responsible management of entrusted resources, taking account of the interests of all stakeholders now and in the longer term"

In a listed company, governance will only be effective if board and shareholders alike play their part in the exercise of stewardship. Asset managers are entrusted with resources by the people who invest their savings through them. The rights and duties of shareholders give them a stewardship role alongside that of directors in protecting the long-term health of the company and promoting the long-term value of the investment. Directors are entrusted by shareholders with the management of the company on a day-to-day basis and are accountable to - and can be influenced by – shareholders. The core responsibility for stewardship is shared between shareholders and directors - a vital point. It follows from this point that the Combined Code will only be fully effective if it is applied equally to shareholders and directors.

"The failure of institutional investors effectively to scrutinise and monitor the decision of boards and executive management in the banking sector, (….) this may reflect the low priority some institutional investors have accorded to governance issues,…. in some cases, they may have even encouraged the risk-taking that proved the downfall of some banks. The Committee is particularly concerned that fragmented and dispersed ownership, combined with the costs of detailed engagement with firms by shareholders, resulted in the phenomenon of 'ownerless corporations'." Treasury Select Committee Report May 2009

The Imbalance in the Current Code

The current wording of the Combined Code is lop-sided by design. It is not intended to deal with the obligations of shareholders, only those of boards. It makes no attempt, therefore, to deal with the current stewardship deficit.

The Institutional Shareholders Committee (ISC) is the combined body that represents pension funds, insurance companies, and fund managers. Its code (updated in 2007) says that "institutional shareholders and/or agents will endeavour to identify problems at an early stage to minimise any loss of shareholder value. If they have concerns and do not propose to sell their holdings, they will seek to ensure that the appropriate members of the investee company's board are made aware of them."

So the obligations of shareholders and of directors are separately stated, in two separate codes. There is no ISC equivalent of the Comply or Explain provisions of the Combined Code. The ISC is supposed to fulfil a co-ordinating function but it is not set up to be a proactive body and is therefore not capable of fulfilling this function. Unfortunately, in spite of all the efforts from Cadbury, Greenbury, Hampel and Higgs, and all the good intentions of the signatories of the ISC, the combined impact of these codes did not protect investors in banks from disastrous shareholder value destruction. This is the background to the current review, and of course to the work of the Walker Committee. There has been a serious failure of stewardship.

In the light of this divided approach to boards and shareholders, it is hardly surprising that stewardship has failed. We need a truly "combined code" for the stewardship of listed companies – one which brings together the obligations of boards with those of institutional shareholders, and which applies to each an equally effective requirement to comply or explain.

Not all of the necessary changes lie within the scope of the FRC. But the current review of the Combined Code represents an opportunity to take the first steps in breaking away from the lop-sided approach to the improvement of UK corporate governance. In the light of the experience of the last two years, we recommend that the new code be redesigned around the principles of stewardship. This would mean that under a successful operation of the revised code, companies are effectively held accountable by shareholders for, and steered by their directors towards, long-term, sustainable performance, and that shareholders accept equal responsibility alongside directors for their part in this stewardship.

Proposed revisions to the combined code to reflect the principles of stewardship

To achieve a truly combined code the following would be the key steps. Only the first of these is within the control of the FRC alone. The others will require joint action with the FSA, the UK government, and ultimately international regulators and representative bodies.

- Spell out the responsibilities of institutional investors in a revised Combined Code (FRC). It is reasonable to expect pension funds representing the interests of beneficial owners to fulfil this function, as should insurance companies, asset managers, sovereign wealth funds and so on. There will be other shareholders who have no intention of acting as stewards but the advantage of a mandatory statement is that the market at least has information on who claims and who does not claim to be a responsible steward.
- In consultation with the ISC devise and recommend "comply or explain" mechanisms through which institutional investors can be properly held to account (FRC with ISC, Department of Business, Financial Services Authority and HM Treasury.) Companies listed in London are required under the code to "comply or explain". The FRC could now work with the ISC to explore parallel arrangements which would require institutional shareholders referred to in D.1 of the code, or at least those "major shareholders" referred to in D.1.2 to do the same as a condition of their "licence to operate" in UK capital markets.
- Introduce a statutory requirement for all institutional investors to define their approach to stewardship, and report regularly to their clients/beneficiaries on their progress in exercising stewardship obligations. Some of these have stated the intention of so doing through signing the Principles of Responsible Investment, but just as companies have the Combined Code to hold them to account, investors need their own mechanism to hold them to account. Those who have already signed up to codes such as the Principles of Responsible Investment could reasonably be expected to disclose the practical steps they have taken and the resources they have devoted to this. (NB this is not at this stage to suggest that there need be a mandatory requirement on investors to engage: simply an obligation to have a clear policy and report against it). (UK Government)
- Initiate and encourage collaborative arrangements among institutional investors to enable them to exercise joint stewardship without excessive cost to any one institution. (FRC and ISC)
- Just as the FRC faces all the challenges of regulating global companies on the basis of where they are listed, so it will face the problem of seeking stewardship commitments from global and mobile investors. If these arrangements can be put in place in London, there may then be a working example which has the potential to be applied across the EU and in other jurisdictions. This move to challenge institutions to define their approach to stewardship is based on the recognition that not all investors can or want to be stewards. Policymakers need to acknowledge the major changes in ownership which we describe in our Tomorrow's Owners report – the growing importance of derivatives and hedge funds, for example, the more rapid turnover of share ownership, the emergence of some categories of shareholder not interested in the long term success of the company, and others with an acute interest in this success, the internationalisation of ownership and the shift from individual to collective shareholding.

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Proposed rewording of Section D1 of the Combined Code - *additional words in italics*

There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. ***For their part institutional shareholders have a collective obligation for ensuring that this dialogue takes place, and where they are not large enough to do this singly for making effective collaborative arrangements to achieve this result.***

The board's role in risk management and remuneration - a wider definition of performance and risk

"Too often seemingly eminent and highly-regarded individuals failed to act as an effective check on, and challenge to, executive managers, instead operating as members of a 'cosy club.' Such incestuous and frankly ineffective behaviour must come to an end."
John McFall, Chairman, Treasury Select Committee speaking on the launch of the Committee's report on the banking crisis.

Whatever the attitude of the owners, stewardship is likely to be compromised if it is based on a restricted understanding of what drives long term success in a company. It is hard to focus on the long term if you have no effective means of assessing long term progress and prospects, and no effective capacity within the organisation to challenge the prevailing view or risk, and enforce the serious consideration of alternative views.

A second weakness in the current governance of listed companies derives from our neglect of the true sources of enduring success. Our investment and governance methodologies lack rigour. They fail to reflect a deep understanding of the drivers of long term business success – leadership, values, relationships, culture and behaviours. Because we do not recognise these factors we do not have the tools or the language or the measurement frameworks to evaluate the company's potential for longer term success, or properly to manage its risk.

The two failures reinforce each other. If we had a clear metric for separating companies with wholesome cultures from companies with flawed cultures, it would be easier for investors to exercise stewardship. If investors or their proxies were more interested in stewardship, there would be more demand by companies for such metrics and managers would behave better. We have to find a way, short of Sarbanes-Oxley style prescription, of creating the pressures whereby metrics will reinforce the stewardship and the stewardship will reinforce the metrics.

As the hearings of the Treasury Select Committee demonstrated, it is becoming ever clearer that, in different ways, it was too difficult for employees or managers in HBOS and RBS to challenge dominant colleagues. Culture influences behaviours. Behaviours constrain both health discussion and disclosure. The case is growing for some mechanism for assessing the soundness of a company's culture and behaviours, and the extent to which there is a healthy capacity for divergent thinking and challenge in the organisation's leadership and in its governance.

As part of our work on Innovation, Risk and Governance, Tomorrow's Company is undertaking further work on these issues and we will present our ideas to the FRC in due course.

These ideas build on the arguments presented by Tomorrow's Company in its 2002 evidence to Higgs. (See Appendix Two) We argued then that an independent director is someone who should from time to time be visiting sites, having lunch in the staff canteen, and demonstrating approachability and picking up a sense of what is really going on in the business. Informal board dinners would allow the independent directors to pool their impressions from these visits. The 2002 evidence also pointed to the reality of the unitary principle, whereby all directors whether executive or non-executive, share a common duty when they become directors and need to acquire a critical detachment from their previous roles.

What gets measured gets managed. The informal "finger of the pulse" needs to be accompanied by more formal methodologies. FRC could help facilitate and reward best practice in this area, by strengthening the parts of the current code that cover financial reporting (C1) and the constructive use of the AGM (D2). The Business Review could be extended to ensure a proper report which covers not only financial performance but also business behaviours, impacts and relationships which have material effect on performance. The FRC might also care to note that the King III review of corporate governance in South Africa now calls for integrated reporting which includes environmental, social and governance issues.

Proposed rewording to Main Principle
(The opening statement at the start of the Combined Code) – *additional words in italics*

Every company should be headed by an effective board, which is collectively responsible for the success of the company.

Supporting Principles
The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls ***and appropriate behaviours*** which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set ***and uphold*** the company's values and standards and ensure that its obligations to its shareholders and others are understood and met. All directors must take decisions objectively in the interests of the company.

The same logic also needs to be applied to the Code's guidance on remuneration.

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Remuneration

The current combined Code says

"The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels."

In our 2004 Inquiry *Restoring Trust*, the Inquiry Team called for creative thinking about the design of compensation packages which relate to long-term performance. This has now begun to happen, as is evidenced, for example, by the decision of BT to introduce elements of claw back into their bonus arrangements.

Our recommendation is that the Combined Code should be much clearer on the need for longer-term incentives, and on the need for companies to explain the rationale that drives their remuneration.

Every enduring organisation has to balance the pressures for immediate performance with the need to invest in the conditions that will drive future performance, and remuneration policies need to reflect this balance. Otherwise the executives will perform in ways that may serve the needs of immediate shareholder return but not meet the test of stewardship. The Code needs amending to reflect this balance and in Appendix One we have made the necessary adjustments which:

- Broaden the definition of performance into the areas of relationships, impacts and behaviours;
- Stretch the timescales over which performance is measured and rewarded to reflect the whole period over which directors' contribution is assessed and rewarded;
- Require the Remuneration Committee to explain differentials in the business and the rationale linking the highest and lowest levels of pay in the company, recognising that this is a matter of appropriate deployment of company funds but also a matter of public legitimacy.

Proposed changes in Schedule 1 (Remuneration) - a*dditional words in italics*

1. The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to enhance shareholder value ***over the medium and long term.*** Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period ***and other ways of withholding rewards until the full impact of the executives' contribution can be assessed.***

Appendix One: Recommendations for Change in the Wording of the Combined Code

We therefore recommend that the FRC amend the Combined Code as indicated in *italics* and ~~strikethrough~~ below. Once we have submitted the evidence from our work with BERR on Risk, Innovation and Governance we may also have further drafting changes to add.

Main Principle

Every company should be headed by an effective board, which is collectively responsible for the success of the company.

Supporting Principles

The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls ***and appropriate behaviours*** which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should **set *and uphold*** the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.
All directors must take decisions objectively in the interests of the company. As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on **strategy *and behaviours.*** Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.

Code Provisions

A.1.1 The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management. ***It should also report on the values and behaviours of the company and on the steps taken to manage the risk that arise in companies from these areas.***
A.1.2 The annual report should identify the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees. It should also set out the number of meetings of the board and those committees and individual attendance by directors[1].
A.1.3 The chairman should hold meetings with the non-executive directors without the executives present. Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance (as described in A.6.1) and on such other occasions as are deemed appropriate.
A.1.4 Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes. On resignation, a nonexecutive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.
A.1.5 The company should arrange appropriate insurance cover in respect of legal action against its directors.

[1] Provisions A.1.1 and A.1.2 overlap with FSA Rule DTR 7.2.7 R; Provision A.1.2 also overlaps with DTR 7.1.5 R (see Schedule C).

A.2 Chairman and Chief Executive

Main Principle

There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.

Supporting Principle

The chairman is responsible for leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda. The chairman is also responsible for ensuring that the directors receive accurate, timely and clear information. The chairman should ensure effective communication with shareholders. The chairman should also facilitate the effective contribution of non-executive directors in particular ***ensuring that all are engaged in visiting company locations and engaging with a cross-section of company staff and stakeholders in a way that signals their accessibility and informs their contribution at the board.***
The Chairman should also ~~and~~ ensure constructive relations between executive and non-executive directors.

Code Provisions

A.2.1 The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board.
A.2.2 The chairman should on appointment meet the independence criteria set out in A.3.1 below. A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report[2].

A.3 Board Balance and Independence

Main Principle

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

Supporting Principles

The board should not be so large as to be unwieldy. The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business and that changes to the board's composition can be managed without undue disruption. To ensure that power and information are not concentrated in one or two individuals, there should be a strong presence on the board of both executive and non-executive directors.
The value of ensuring that committee membership is refreshed and that undue reliance is not placed on particular individuals should be taken into account in deciding chairmanship and membership of committees.
No one other than the committee chairman and members is entitled to be present at a meeting of the nomination, audit or remuneration committee, but others may attend at the invitation of the committee.

[2] Compliance or otherwise with this provision need only be reported for the year in which the appointment is made

Code provisions

A.3.1 The board should identify in the annual report each non-executive director it considers to be independent[3]. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

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

A.3.2 Except for smaller companies[4], at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.

A.3.3 The board should appoint one of the independent non-executives directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve or for which such contact is inappropriate.

A.4 Appointments to the Board

Main Principle

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

Supporting Principles

Appointments to the board should be made on merit and against objective criteria. Care should be taken to ensure that appointees have enough time available to devote to the job. This is particularly important in the case of chairmanships.

The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board.

Code Provisions

A.4.1 There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the

[3] A.2.2 states that the chairman should, on appointment, meet the independence criteria set out in this provision, but thereafter the test of independence is not appropriate in relation to the chairman.

[4] A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship. The nomination committee should make available[5] its terms of reference, explaining its role and the authority delegated to it by the board.

A.4.2 The nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.

A.4.3 For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises. A chairman's other significant commitments should be disclosed to the board before appointment and included in the annual report. Changes to such commitments should be reported to the board as they arise, and their impact explained in the next annual report.

A.4.4 The terms and conditions of appointment of non-executive directors should be made available for inspection[6]. The letter of appointment should set out the expected time commitment. Non-executive directors should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment, with a broad indication of the time involved and the board should be informed of subsequent changes.

A.4.5 The board should not agree to a full time executive director taking on more than one non-executive directorship in a FTSE 100 company nor the chairmanship of such a company.

A.4.6 A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments[7]. An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director.

A.5 Information and Professional Development

Main Principle

The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge. *All directors should be expected in time to obtain Chartered Director status or equivalent standards of professional development*.

Supporting Principles

The chairman is responsible for ensuring that the directors receive accurate, timely and clear information. Management has an obligation to provide such information but directors should seek clarification or amplification where necessary.

The chairman should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities. ***All directors should be expected to obtain Chartered Director status and any director not having or undertaking this or equivalent professional development should provide a statement of explanation to shareholders in the appropriate section of the Annual Report.***

[5] The requirement to make the information available would be met by including the information on a website that is maintained by or on behalf of the company.

[6] The terms and conditions of appointment of non-executive directors should be made available for inspection by any person at the company's registered office during normal business hours and at the AGM (for 15 minutes prior to the meeting and during the meeting).

[7] This provision overlaps with FSA Rule DTR 7.2.7 R (see Schedule C).

Under the direction of the chairman, the company secretary's responsibilities include ensuring good information flows within the board and its committees and between senior management and nonexecutive directors, as well as facilitating induction and assisting with professional development as required.
The company secretary should be responsible for advising the board through the chairman on all governance matters.

Code Provisions

A.5.1 The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this, the company should offer to major shareholders the opportunity to meet a new nonexecutive director.
A.5.2 The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. Committees should be provided with sufficient resources to undertake their duties.
A.5.3 All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are complied with. Both the appointment and removal of the company secretary should be a matter for the board as a whole.

A.6 Performance Evaluation

Main Principle

The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

Supporting Principle

Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties). The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.

Code Provision

A.6.1 The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

A.7 Re-election

Main Principle

All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board.

Code Provisions

A.7.1 All directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years. The names of directors submitted

for election or re-election should be accompanied by sufficient biographical details and any other relevant information to enable shareholders to take an informed decision on their election.
A.7.2 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Acts provisions relating to the removal of a director. The board should set out to shareholders in the papers accompanying a resolution to elect a non-executive director why they believe an individual should be elected. The chairman should confirm to shareholders when proposing re-election that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role. Any term beyond six years (e.g. two three-year terms) for a non-executive director should be subject to particularly rigorous review, and should take into account the need for progressive refreshing of the board. Non-executive directors may serve longer than nine years (e.g. three three-year terms), subject to annual re-election. Serving more than nine years could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).

B. Remuneration

B.1 The Level and Make-up of Remuneration

Main Principles

Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to *long-term* corporate and individual performance. *The board should publish the ratio between the highest and lowest paid directors/employees in the company and provide its statement of the market or other justifications for these differentials.*

Supporting Principle

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance. They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases ***and be able to explain the total remuneration rationale of the group as a whole from top to bottom.***

Code Provisions

Remuneration policy

B.1.1 The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels. ***Performance does not only mean financial performance: the remuneration committee should also ensure that the remuneration packages place due emphasis on values and behaviours necessary for the business to manage risk.*** In designing schemes of performance-related remuneration, the remuneration committee should follow the provisions in Schedule A to this Code.
B.1.2 Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.
B.1.3 Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for nonexecutive directors should not include share options. If, exceptionally, options are

granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).
B.1.4 Where a company releases an executive director to serve as a nonexecutive director elsewhere, the remuneration report[8] should include a statement as to whether or not the director will retain such earnings and, if so, what the remuneration is.

Service Contracts and Compensation

B.1.5 The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.
B.1.6 Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

B.2 Procedure

Main Principle

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

Supporting Principles

The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.
The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

Code Provisions

B.2.1 The board should establish a remuneration committee of at least three, or in the case of smaller companies[9] two, independent non-executive directors. In addition the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. The remuneration committee should make available[10] its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, a statement should be made available[11] of whether they have any other connection with the company.
B.2.2 The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.

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[8] As required under the Directors' Remuneration Report Regulations 2002.
[9] See footnote 4.
[10] This provision overlaps with FSA Rule DTR 7.2.7 R (see Schedule C).
[11] See footnote 5.

B.2.3 The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.
B.2.4 Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

C. Accountability and Audit

C.1 Financial Reporting

Main Principle

The board should present a balanced and understandable assessment of the company's position and prospects. *This covers not only financial performance but business behaviours, impacts and relationships which have a material effect on performance.*

Supporting Principle

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

Code Provisions

C.1.1 The directors should explain in the annual report their responsibility for preparing the accounts and there should be a statement by the auditors about their reporting responsibilities.
C.1.2 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

C.2 Internal Control[12]

Main Principle

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

Code Provision

C.2.1 The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so[13]. The review should cover all material controls, including financial, operational, ***behavioural*** and compliance controls and risk management systems.

[12] The Turnbull guidance suggests means of applying this part of the Code. Copies are available at www.frc.org.uk/corporate/internalcontrol.cfm
[13] In addition FSA Rule DTR 7.2.5 R requires companies to describe the main features of the internal control and risk management systems in relation to the financial reporting process (see Schedule C).

C.3 Audit Committee and Auditors[14]

Main Principle

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

Code provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies[15] two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience[16].

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include[17]:

- to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board should be made available[18]. A separate section of the annual report should describe the work of the committee in discharging those responsibilities[19].

C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

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[14] The Smith guidance suggests means of applying this part of the Code. Copies are available at www.frc.org.uk/corporate/auditcommittees.cfm

[15] See footnote 4.

[16] This provision overlaps with FSA Rule DTR 7.1.1 R (see Schedule C).

[17] This provision overlaps with FSA Rules DTR 7.1.3 R (see Schedule C).

[18] See footnote 5.

[19] This provision overlaps with FSA Rules DTR 7.1.5 R and 7.2.7 R (see Schedule C).

C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.
C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

D. Relations with Shareholders

D.1 Dialogue with Institutional Shareholders

Main Principle

There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place[20]. ***For their part institutional shareholders have a collective obligation for ensuring that this dialogue takes place, and where they are not large enough to do this singly for making effective collaborative arrangements to achieve this result.***

Supporting Principles

Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman (and the senior independent director and other directors as appropriate) should maintain sufficient contact with major shareholders to understand their issues and concerns.
The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.
Institutional Shareholders should maintain regular contact with the company and have a clear statement of stewardship principles on which to base their engagement. The company should be willing to spend more time with shareholders who show a deep interest in the company, rather than simply engaging with the largest shareholders.

Code Provisions

D.1.1 The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. Non-executive directors should be offered the opportunity to attend meetings with major shareholders and should expect to attend them if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.
D.1.2 The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion. ***Equally institutional shareholders should show an equivalent level of accountability to their beneficiaries for the steps they have taken to ensure that companies in which they have a stake uphold their stewardship principles.***

[20] Nothing in these principles or provisions should be taken to override the general requirements of law to treat shareholders equally in access to information.

D.2 Constructive Use of the AGM

Main Principle

The board should use the AGM to communicate with investors and to encourage their participation *not only about financial results and remuneration, but also about the full range of relationships, behaviours and impacts that affect the company's future performance.*

Code Provisions

D.2.1 At any general meeting, the company should propose a separate resolution on each substantially separate issue, and should in particular propose a resolution at the AGM relating to the report and accounts. For each resolution, proxy appointment forms should provide shareholders with the option to direct their proxy to vote either for or against the resolution or to withhold their vote. The proxy form and any announcement of the results of a vote should make it clear that a 'vote withheld' is not a vote in law and will not be counted in the calculation of the proportion of the votes for and against the resolution.

D.2.2 The company should ensure that all valid proxy appointments received for general meetings are properly recorded and counted. For each resolution, after a vote has been taken, except where taken on a poll, the company should ensure that the following information is given at the meeting and made available as soon as reasonably practicable on a website which is maintained by or on behalf of the company:

- the number of shares in respect of which proxy appointments have been validly made;
- the number of votes for the resolution;
- the number of votes against the resolution; and
- the number of shares in respect of which the vote was directed to be withheld.

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

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

Section 2: Institutional Shareholders

E. Institutional Shareholders[21]

E.1 Dialogue with companies

Main Principle

Institutional shareholders should *have a clearly defined approach to their stewardship responsibilities which is made clear to their clients/beneficiaries and upon which they should report regularly. They should* enter into a dialogue with companies based on the mutual understanding of *their investment* objectives *and stewardship principles. Where it is not feasible for an individual institution to engage in this dialogue on their own they should engage in collaborative arrangements and they should disclose at least annual what these arrangements are and how they have discharged this obligation.*

[21] Agents such as investment managers, or voting services, are frequently appointed by institutional shareholders to act on their behalf and these principles should accordingly be read as applying where appropriate to the agents of institutional shareholders.

Supporting Principles

Institutional shareholders should apply the principles set out in the Institutional Shareholders' Committee's ''The Responsibilities of Institutional Shareholders and Agents – Statement of Principles''[22], which should be reflected in fund manager contracts. ***They should define their view of their stewardship obligations and report regularly on their fulfilment of the stewardship commitments that they have made.***

E.2 Evaluation of Governance Disclosures

Main Principle

When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention, ***including the effectiveness of the company's management of risk associated with its employees' behaviour.***

Supporting Principle

Institutional shareholders should consider carefully explanations given for departure from this Code and make reasoned judgements in each case. They should give an explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position. They should avoid a box-ticking approach to assessing a company's corporate governance. They should bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces. ***This includes evidence to assure them that the companies in which they are invested have a sound culture, and in particular are not at risk through the excessive domination of senior executives.***

E.3 Shareholder Voting

Main Principle

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

Supporting Principles

Institutional shareholders should take steps to ensure their voting intentions are being translated into practice.
Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.
Major shareholders should attend AGMs where appropriate and practicable. Companies and registrars should facilitate this.

Schedule A: Provisions on the design of performance related remuneration

1. The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to enhance shareholder value ***over the medium and long term.*** Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period ***and other ways of withholding rewards until the full impact of the executives' contribution can be assessed.***
2. The remuneration committee should consider whether the directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive

[22] available at www.institutionalshareholderscommittee.co.uk

scheme. In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities. 3. Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or at least form part of a well considered overall plan, incorporating existing schemes. The total rewards potentially available should not be excessive.
4. Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives. Consideration should be given to criteria which reflect the company's ***medium and long term*** performance relative to a group of comparator companies in some key variables such as total shareholder return.
5. Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.
6. In general, only basic salary should be pensionable.
7. The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

Schedule B: Guidance on liability of non-executive directors: care, skill and diligence

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

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

- The letter of appointment of the director should set out the expected time commitment (Code provision A.4.4); and
- The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. The chairman is responsible for ensuring that the directors are provided by management with accurate, timely and clear information. (Code principle A.5).

(ii) Non-executive directors should themselves:

- Undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company (Code principle A.5 and provision A.5.1)
- Seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice. (Code principle A.5 and provision A.5.2)
- Where they have concerns about the running of the company or a proposed action, ensure that these are addressed by the board and, to the extent that they are not resolved, ensure that they are recorded in the board minutes (Code provision A.1.4).
- Give a statement to the board if they have such unresolved concerns on resignation (Code provision A.1.4)

3. It is up to each non-executive director to reach a view as to what is necessary in particular circumstances to comply with the duty of care, skill and diligence they owe as a director to the company. In considering whether or not a person is in breach of that duty, a court would take into account all relevant circumstances. These may include having regard to the above where relevant to the issue of liability of a non-executive director.

Appendix Two: The Non-Existent Non-Executive

Tomorrow's Company Response to the DTI Review of the role and effectiveness of non-executive directors (2002)

Executive Summary

- There is a flaw in the terms of reference for this Review. This is because there is a conflict between law and practice in the UK. The law does not recognise a separate category of "non-executive" director. In law all directors are the same.
- In everyday business practice executives and non-executives are treated differently, but there is no evidence that this separation has led to an improvement in governance. The effective choice is whether to reflect current practice in the law, or whether to change practice to reflect the unitary principle implied by the law.
- The Review should take the second option and recognise that direction of the company is distinct from management. All directors are part time and should have the same contract. Some, "the inside directors", have a separate role as executives.
- This has implications for the engagement, appraisal, remuneration, training and development of all directors. To fulfil their duties effectively directors should not have more than four directorships.
- Directors owe a duty to the company. They are accountable to shareholders and responsible for the company's purpose, values and success and for all stakeholder relationships.
- To fulfil these duties the board must widen the scope of its agenda and competence in an inclusive way which covers not only financial risk but the drivers of future success – for example reputation, innovation and key relationships.
- The chairman's role needs strengthening to reflect the legal position of chairman of the board and to ensure the proper recruitment, operation and professional development of the whole board.
- Targets should be established to reinforce the continuing professional development of all directors. Within 5 years every listed company should have at least two directors who have achieved Chartered Director status. Within ten years every member of the board should have this or be undergoing the necessary training.
- There should be a new corporate governance code for all directors. The code would be values-based, and derived from the "Ten duties of directors" currently being developed by the Commonwealth Association of Corporate Governance. Enforcement of the code should be by disclosure, not box-ticking compliance.

1. **Legitimacy: upholding the law**
2. **Upholding the three fundamental values of Corporate governance:**
    - Accountability – corporately as a board and individually for directors' actions on behalf of owners
    - Openness

- Probity – the responsibility to act honestly and in a trustworthy manner, never putting personal interests or the interests of another organisation above those of the company

3. **Transparency - openly following an agreed and rigorous process of decision-making, and a willingness to be appraised for effectiveness in doing so**
4. **Upholding the primary loyalty of a director – which is to the company**
5. **The duty of care – to exercise the roles and task of a director competently**
6. **The duty of critical review and independent thought**
7. **The duty of delivering the primary roles and tasks of the board: formulating policy, strategic thinking, supervising management ensuring accountability**
8. **The duty of protecting minority shareholders**
9. **The duty of corporate social responsibility**
10. **The duty of learning, developing and communicating**

Appendix Three: the Virtuous Circle of Governance

The virtuous circle of governance is a joined-up way of thinking about success. It means linking together every conversation about business planning, measurement, and the boardroom agenda, with the production/audit of the annual report (and other reports), the annual meeting, and stakeholder dialogue – all as part of the same logic.

Reporting on performance provides verification of whether or not the company has achieved what it set out to do. This in turn allows it to understand whether or not it has correctly identified its key relationships and success model, and to change these as necessary. This allows it to define how to measure its success model, so that it can be communicated.

There is also another set of impacts that flow in the opposite direction. Communicating (for example through an annual report) forces the company to define what measures it is going to report on. This in turn forces it to be clear about what its success model is, and what the key relationships are that enable that model to succeed. This also forces the company to be clear about what it means by success: what it is setting out to achieve.

This is why companies find non-financial reporting difficult – because it forces them to be explicit about the success they seek and what drives it. It also explains why those that choose to grasp the nettle gain so much benefit from doing so.