The Role of a Non-Executive Director

Expert knowledge means success

Contents

Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

More and more companies - both public and private - are appointing non-executive directors to their Board. Why has the appointment of non-executives become so acceptable to so many companies? The answer lies in the requirement for boards of directors to demonstrate the acceptance of corporate governance. Independent non-executive directors are mainly valued for:

- Their objective judgement of corporate affairs; and
- Having extensive experience in business and management.

As the name "non-executive" implies these are directors who, although members of the board, do not carry out day-to-day executive functions. In the past, they were little more than well known "titled" or "City" names whose appearance on the published list of directors provided a degree of respectability - particularly when a company was looking to raise capital. It also enhanced (or so people thought) the image of a company over its competitors. Today, the tendency is for non-executive directors to be appointed either because they have specialist knowledge or because they have important contacts and experience in certain aspects of the company's business.

Although non-executives may have a specific skill that can be exercised from time to time for the benefit of the company appointing them, their main contribution will be rated by their overall knowledge and wisdom.

In small to privately owned companies, only in recent years have non-executive appointments been made. Not too many years ago, non-executives were considered somewhat of a luxury but today, companies of all sizes recognise the important and valuable benefits of bringing an independent director on board. This is due in part to the requirement by equity investors, principally venture capitalists, that an independent director be appointed to monitor the finances and provide wise guidance and advice. Although this requirement may at first be reluctantly accepted as part of a fund-raising exercise, many small companies soon find that the appointee enhances the effectiveness of their board of directors.

One of the main problems in appointing a non-executive director is finding the right person - at the outset, it's best to spend some time in fully defining the role the appointee is to play in the company. Finding the right individuals with relevant experience to act as valued advisors takes time and the right skills. But, how do you measure the qualifications of a director when considering a non-executive appointment?

One way to possibly get the right person is to insist that they hold the Chartered Director qualification - this is now available from the Institute of Directors to candidates who successfully complete the examination and an in-depth interview to review their personal portfolio of experience. Candidates for the Chartered Director qualification must:

- Be graduates, or members of a professional body;
- Have experience serving on a board dealing with matters of direction and governance rather than only in operational management; and
- Undertake to adhere to the Code of Practice and maintain continuing professional development.

The best course of action for someone wishing to become an independent director is to build on his or her own business experience and develop judgment by exposing and testing this knowledge and experience in many different situations and learning from a wide cross-section of individuals.

Research carried out by NOP Research Group on behalf of the *Independent Director*[1] initiative shows that companies that do appoint non-executive directors generally exceed the Combined Code's recommended ratio of non-executive directors to executive directors. But the survey also suggests that there is still a high percentage of companies (including some listed companies) that do not appoint non-executive directors and also have no plans to recruit any in the future.

NEDS must register to comply with Money Laundering Regulations

NEDS who receive fees (rather than payment as an employee) for their services are classed as "company service providers" under the Money Laundering Regulations and were therefore legally obliged to register as such with HM Revenue and Customs by 1 April 2008.

NEDS are now required to make and record proper checks on the companies on whose boards they sit and on the "beneficial owners" of those companies".

For more information see our publication *IP516: The Money Laundering Regulations*

Is Your Company Too Small for a NED?

Smaller companies lag behind bigger companies in employing non-executive directors, despite the benefits they can bring in terms of knowledge, independence and strategic vision. According to recent research by BT for The Sunday Times Enterprise Network:

- Only 40% of medium-sized businesses employ non-executive directors.
- Within the middle-market sector, bigger companies are more likely to have non-executives.
- One-third of companies with sales of between £5m and £10m have non-executive directors, compared with nearly half of those with sales between £11m and £50m.
- More than half of medium-sized businesses think they are too small to warrant having them.

The Role of the Non-Executive Director

An independent non-executive provides a balancing influence. He/she should ensure that the executive directors, who are responsible for the day-to-day control of a company, take into account the strategic long-term future of the business and consider the often-conflicting interests of the various stakeholders - shareholders, lenders, employees, customers and so on. Some of the ways in which an experienced non-executive director can contribute to the development of a growing business are in:

- Providing specialist industrial, commercial or professional expertise;
- Contributing to strategic development and "auditing" of business strategy proposed by executives;
- Making introductions to and facilitating relationships with third parties;
- Raising the company's profile.

Where existing directors are relatively new to formal and structured company procedures, the non-executive's role should also focus on:

- Improving board procedures;
- Objective assessment of the performance of the company;
- Assisting in promoting management changes and reviewing business strategy;
- Guidance on the principles of corporate governance (and company law) and monitoring compliance with best practice.

The Need for Independence

Although (at least in theory) a strong non-executive can act as a counterbalance to a forceful and demanding managing director, in practice this combination rarely works on its own. To be effective, any non-executive must be seen to be truly independent. A truly independent non-executive director ought to be prepared to resign when they find themselves in serious disagreement with other directors over board policy.

Independence is likely to be compromised if a non-executive:

- Is or has recently been employed by the company;
- Is employed by a major customer or supplier;
- Is related to other board members or senior management;
- Is retained as a professional adviser, or is a partner in a firm advising the company; or
- Is financially dependent upon the remuneration received - but, non-executives should be sufficiently rewarded otherwise companies will be unable to attract people of stature who will take the trouble to learn about the company and make a contribution.

Directors should be independent of the chairman and other directors - including those who are executive and non-executive.

Non-Executives and Independent Directors

All non-executives should be independent, but sometimes an independent director may assume a short-term executive role. Generally, all independent Directors should not be rewarded by share options or bonus schemes if they are to be truly independent. But in some situations, it may be appropriate to reward them based on results - such as where a company doctor is brought in to rescue the company. This is the point at which where the Non-Executive and Independent Director roles diverge.

Responsibilities

Codes of practice from the Greenbury, Cadbury and Hampel Committees, together with increasing pressure from institutional investors and other requirements, have affected the role of the non-executive director, which is now under more scrutiny than ever before. Non-executive directors:

- Are required to have a view of the company's affairs, which is independent from that of the executive directors;

How companies benefit from Non-Execs

"Studies have shown that companies benefit significantly from having independent, non executive directors on their boards. Their breadth of view, especially in the areas of strategy, independent thinking and knowledge, complement the daily business focus of executive directors. The combination of these in the boardroom gives an organisation the best opportunity to succeed in today's business world."

Peter Coppard
Managing Director,
NRS Ltd

- Are expected to get sufficiently close to the business to understand its risks in some detail while maintaining both a strategic and monitoring position;
- Should not relying on management alone to provide enough information to enable the non-executive to carry out this role;
- Must know the right questions to ask to ensure they have the information necessary to carry out their duties efficiently.

Non-executive directors must remember that they certain duties of care and diligence as laid down in both statutory and common law. They have a fiduciary duty to act honestly and in the best interests of the company as a whole. In addition:

- They must not use their position or any information they have access to by virtue of their position as a company director for any improper purpose;
- They must not allow their personal interests or those associated persons to conflict with the interests of the Company.

Qualities Required

Non-executive directors appointed to a board of directors should have extensive experience in business and management as well as the following personal characteristics:

- Strong inter-personal skills;
- The ability to assess and to handle people;
- The strength of mind to hold one's ground - this means having the fortitude to hold an opinion or carry through a proper course of action even though it might mean unpopularity or being voted off the board;
- Financial numeracy;
- A challenging but constructive approach to reviewing board policy and strategy;
- The capacity to motivate executive directors;
- Financial independence;
- An awareness of the legal environment and obligations to the various parties;
- Familiarity with board practice;
- The ability to act as the chairman's sounding board.

The role of an independent non-executive changes as a company grows from a start-up stage to, eventually, a quoted company with outside shareholders. The different tasks and problems faced by board and management vary considerably through this transition - even so, certain qualities are always needed - such as those listed above.

Terms of office

Non-executive directors ought to have a specific term of office (as should executive directors) and be subject to the usual re-election process. As one of the objectives of appointing non-executives is to bring in either specialist knowledge or fresh ideas, a relatively short period of office, of say three to five years, might be appropriate.

Preliminary enquiries

As the effectiveness of any director is materially dependent upon the quality of management information produced, the independent non-executive director is particularly at risk if the information produced by the company's management is neither accurate nor timely. An independent director bears the same legal responsibilities as the executive directors but achieves effectiveness by influencing decisions rather than controlling operations - a prospective non-executive director is well advised to make sure that the company has adequate procedures and systems of internal control in place and that the financial management information produced is reliable, accurate and up to date.

Remuneration

While it may be appropriate for non-executive directors to be remunerated partly in shares, non-executive directors should not receive:

- Share options;
- Other performance-related pay;
- Compensation on the termination of their appointment.

The Hampel Report expresses no objection to paying a non-executive director's remuneration in the form of company shares, but does not recommend this as universal practice. It is clear that many companies in the UK have established option and share plans for directors, but while some of these are being re-examined, only a minority are being discontinued.

Even smaller companies can benefit

"... particularly in smaller companies, NEDs may contribute valuable experience not otherwise available to management."

(Hampel, 1998, page 25)

ICGN NED Remuneration Guidelines and Policies

New Non-Executive Director Remuneration Guidelines and Policies have been published by the International Corporate Governance Network (ICGN). It has been developed by the ICGN Remuneration Committee in consultation with ICGN members. The guidelines are intended to apply to listed companies globally and recommend:

- Clear and comprehensive disclosure of the remuneration of non-executive directors;
- Alignment of interests between non-executive directors and shareholders;
- Equity based remuneration should vest fully on the grant date; and
- Cash remuneration should only be paid in relation to the annual retainer or fee.

The ICGN is a global membership organisation of around 470 leaders in corporate governance based in 45 countries with investors collectively representing funds under management of around US$9.5 trillion.

Source: www.icgn.org/files/icgn_main/pdfs/news/icgn_ned_rem_guidelines_(short).pdf

What is the cost of a Non-Executive Director?

Having an effective independent non-executive director can be very cost effective. The costs can be fairly modest compared with employing consultants - for medium-sized businesses the fees typically range from £500 to £1,500 a day and the number of days contracted varies between few as three to four days a year to as many as 36. The average is 18 days a year[2].

The salary payable varies according to the size of company, the responsibilities involved and the frequency and length of meetings. Companies with formal committees reviewing audit, nomination (for board appointments) and executive remuneration can expect to pay their non-executives more because of the additional work and responsibility involved.

The scale of annual salary for a non-executive chairman can start at £5,000 but in larger companies this might amount to £50,000 a year or more - a chairman's salary is likely to be some 20% or so above the rate payable to other non-executives.

Non-Executives - the Investors Perspective

Institutional investors - such as pension funds and insurance companies - strongly support the presence of independent non-executive directors on the boards of companies. There has been a growing awareness of the value of audit committees and the importance of non-executive directors has become evident, particularly in matters concerning remuneration of the senior management and in circumstances where there is potential for conflict of interest such as management buy-outs.

Non-executives have a primary function to comment on corporate strategy where they can bring an objectivity and independence of view borne by their outside experience. While it is recognised that in some instances professional advisers bring their own particular expertise to this role, the value of the independent non-executive director is the independence, personality and experience that he or she can contribute to the deliberations of the Board.

It is suggested that, as a matter of good practice these provisions should be observed:

- The non-executive directors should be sufficient in number and calibre for their views to carry significant weight on the Board. This is particularly necessary if the roles of Chairman and Chief Executive are combined;
- Non-executive directors should be independent, e.g. they should not, under normal circumstances, be offered participation in share option schemes, neither should they be entitled to any compensation on loss of office since such arrangements might impair their impartiality. It is recognised that professional advisers such as merchant bankers and solicitors may well fulfil a specialist role but they should not be regarded as a substitute for the independent non-executive director;
- Non-executive directors should hold other directorships in the same industry only with the approval of the Board;
- While all directors have a duty to monitor the performance of a company, the non-executive directors should acknowledge a duty to monitor the performance of the executive directors, and to report to the shareholders if they are not satisfied after reasonable efforts have been made by them to remedy the causes of their dissatisfaction.

Before investing and while remaining as investors, venture capitalists and institutional investors look at these issues:

- Are the directors paying themselves too much?
- Are directors' service agreements too generous in the contract term and notice provisions?
- Does the Company have a defined achievable strategy?
- How will pursuit of the proposed corporate strategy be financed??
- Does the company have the necessary accounting procedures in place?

And, most of all:

- Does the board of directors have appropriate non-executive directors in place?

On the last point above, the board of directors should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the decision taking process of the board.

"It is now widely accepted that boards gain from a combination of the breadth of view of outside directors and the depth of knowledge of the executive directors."

(Cadbury, 1994, page vii)

Responsibilities of the Chairman

A list of responsibilities of the chairman of the Board includes:

- Adopting a leadership role of the conduct of the Board's responsibilities;
- Leading and managing the Board in the discharge of its duties;
- Ensuring that the Board is in a position to perform and does perform its responsibilities;
- Setting the agenda for the performance of the Board's responsibilities;
- Ensuring that Board meetings take place with sufficient frequency and length with adequate information;
- Ensuring that the Board is kept properly informed of and understands the financial position and performance of the Company (generally, through an effective audit committee);
- Monitoring of management and assessment of the Company's financial position and performance;
- Detection of any material adverse developments;
- Ensuring the provision and availability of material financial information to enable the Board to discharge its responsibilities;
- Ensuring that person appointed as financial director has appropriate qualifications, expertise and experience;
- Ensuring that the Board as a whole, and in particular the non-executive directors, fully understand the strategic direction proposed by the chief executive and, where appropriate, to require that an external strategic audit is undertaken particularly in the case of technology and complex technical matters;
- Being satisfied about the accuracy of public statements made on the Company's behalf and the Company's compliance with the rules of any stock or other exchange to which it belongs; and
- Ensuring that cash flow is properly monitored and that the Board as a whole has a constant understanding of the Company's cash flow position.

Higgs Report

Agenda for Change in the Boardroom

On 20 January 2003[3], Derek Higgs published his report into the role and effectiveness of non-executive directors. It sets out a determined and realistic agenda for change, building on the existing framework of UK corporate governance. The report envisages a more demanding and important role for non-executive directors.

The Review focuses directly on the effectiveness of non-executive directors in promoting company performance as well as on issues of accountability. The recommendations aim to increase rigour and transparency in the appointment process to foster meritocracy and widen the spread of experience in UK boardrooms. These include:

- Proposals to promote meritocracy in the boardroom through an open, fair and rigorous appointments process and to widen the pool of candidates;
- Proposing a new, clear description of the role of the non-executive director;
- That the roles of chairman and chief executive should be separated, and that the chief executive should not go on to become chairman of the same company;
- A new definition of 'independence' that addresses both relationships that would affect a director's objectivity and also those that could appear to do so. At least half the board would need to meet the new test, as would all members of the audit and remuneration committees and a majority of the nomination committee;

How Non-Executives add value

"Independent directors help executive directors to get the most out of their businesses. They provide fresh and objective input into strategic thinking and decision-making. They use their broad business experience and judgement to provide encouragement and watch for pitfalls."

Extract from 3i Plc Independent Directors Programme

- Promoting closer relationships between non-executive directors and major shareholders;
- Significantly improved induction and professional development for directors;
- Recommending that the performance of individual directors and of the board as a whole should be evaluated at least annually;
- Proposals to clarify the liabilities of non-executive directors;
- Recognising that some of the new Code provisions may be less relevant or manageable or take longer to achieve for smaller companies.

Rejecting a legislative approach, Derek Higgs' recommendations build on the current framework of UK corporate governance and the 'comply or explain' nature of the Combined Code.

NED Research

Several reports over the past few years, including those of Higgs and Tyson, have put the role of the non-executive director (NED) in the spotlight. Roffey Park and Cedar International recently examined the changing perception of non-executive directorships, both from the perspective of executive and non-executive directors. Their research suggests that some of the FTSE 100 boards had already begun to try to get more value from their NEDs prior to Higgs. As a result, NEDs have become a more expensive commodity and they themselves view the role as more onerous.

The specific NED tasks identified by the Combined Code on Corporate Governance 2003, relate to:

- the development and constructive challenge of strategy;
- the scrutiny and monitoring of management performance;
- the assurance of the integrity of financial information and risk management; and
- the appointment and remuneration of executives.

In spite of the above guidelines, surveys consistently show a lack of clarity around the NED role. NEDs in Roffey Cedar study were grappling with less tangible aspects of the role such as:

- Understanding the organisation: understanding the true nature of the organisation - the stuff that is not easy to write down so that you cannot do your homework well - the stuff that is built into the walls of the place... coming to terms with that in any organisation takes time, adjustment and hard listening;
- Board dynamics: NEDs have to understand something of the politics and power relationships in order to see how to fit in;
- Spotting the issues: In some cases company difficulties may be buried or disguised in too much information, in others they may remain hidden because of too little information;
- Clarifying the role: While NEDs are usually appointed because of their existing track record some still feel there is room for development;
- When to 'cross the line' between support and challenge: Inevitably the role varies in accordance with organisational needs.

While Higgs found that the only official requirement for selecting NEDs is previous Board or top management experience, the real challenge requires far more emphasis on 'soft' skills. The Roffey Cedar research found that desirable attributes for NEDs included: being analytical, articulate, confident, decisive, emotionally intelligent, honest, independent of spirit, flexible, persuasive, questioning, self-aware, well-prepared and intuitive, having integrity, good judgement, and financial ability.

Roffey Park and Cedar International's research on non-executive directorships was published in September 2005. For further details please contact Teresa Boyle on +44 (0)1293 854065 or e-mail: teresa.boyle@roffeypark.com

The UK Corporate Governance Code and associated guidance

The UK Corporate Governance Code was (formerly called the Combined Code). It sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders.

All companies with a Premium Listing of equity shares in the UK are required under the Listing Rules to report on how they have applied the Combined Code in their annual report and accounts. The relevant section of the Listing Rules can be found at: http://www.frc.org.uk/corporate/ukcgcode.cfm

ICSA guidance on liability of non-executive directors: care, skill and diligence

In January 2013, the *Institute of Chartered Secretaries and Administrators (ICSA)* issued new guidance[4] on the liability of non-executive directors (NED), outlining appropriate steps to exercise care, skill and diligence in the execution of their roles and responsibilities. The guidance is available at: http://www.icsaglobal.com/resources/guidance/130117

This latest ICSA guidance note suggests ways in which NEDs can approach their work which would also allow them to demonstrate to a regulator, or in a court of law, that they had executed all necessary steps to reduce their liability exposure.

Given the recent emphasis the UK Corporate Governance Code places on the role of the NED on the board and its committees, it is important to realise that the time commitment necessary to fulfil the expectations of the role may be significant, and possibly greater than has previously been expected.

The guidance note, advises NEDs on what due diligence should be undertaken before joining a board and on appointment to a board. Emphasis is placed on the skills needed to serve on a particular board, which would provide a NED with 'independence, oversight and the confidence to constructively challenge a board'.

Areas of best practice for NEDs outlined in this guidance note include:

- Taking responsibility for their own on-going training and continuous development
- Being prepared to provide independent oversight and constructive challenge;
- Insisting on receiving high-quality information;
- Making decisions objectively in the interests in the company and
- Avoiding conflicts of interest.

Organisations for Non-Executive Directors

The following organisations provide information or services relating to non-executive directors - either in relation to those seeking NED roles or for companies looking to recruit suitable candidates to join their board:

The NED Exchange
Website: http://www.nedexchange.co.uk/

The Independent Director
Tel: +44 (0) 1794 884 070
Website: http://www.nonexec.com/home.htm
Institute of Directors
116 Pall Mall, London, SW1Y 5ED
Tel: +44 (0) 207 839 1233
Website: http://www.iod.com

Executives Online
Tel: +44 (0) 845 053 1188
Website: www.ExecutivesOnline.co.uk

The Financial Times Non-Executive Director' **Club**
Website: www.non-execs.com

The Non-Executive Directorship Exchange
Website:
http://www.nedexchange.co.uk/jobs/index.htm

New Life Network
Website: http://www.newlifenetwork.co.uk/non-executive-directorships-c86.html

Non-Ex**ecutive Directors' Association**
Website: http://www.nedaglobal.com/

Non-Executive Director
Website:
http://www.nonexecdirector.co.uk/index.asp

Further Information

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

References:

[1] The Independent Director is a joint initiative between Ernst & Young and the Institute of Directors.

[2] Source: Research by BT for The Sunday Times Enterprise Network.

[3] In April 2002, Derek Higgs was appointed by the Secretary of State for Trade and Industry and the Chancellor to lead a short independent Review into the role and effectiveness of non-executive directors. The terms of reference required the Review to build and publish an accurate picture of the status quo, to lead a debate on the issues and to make such recommendations as thought appropriate by the Reviewer to clarify the role and increase the effectiveness of non-executive directors. Copies of the Higgs Review and associated research can be obtained from the Review's website at: www.bis.gov.uk/files/file23012.pdf

[4] See: http://www.icsaglobal.com/governance-and-compliance/news/january-2013-icsa-issues-guidance-on-the-role-of-ned

Important Notice

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