



Non-executive directors

Summary of the Higgs report on the role and effectiveness on non-executive directors

20 January 2003

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Introduction

The enquiry led by Derek Higgs, experienced City investment banker, appointed by the government to look into the role and effectiveness of non-executive directors (NEDs) reported on 20 January 2003. The report does not propose a prescriptive rules-based framework on the duties of NEDs, but rather forms the basis for additional Combined Code recommendations together with additional guidance focusing on the independence and effectiveness of non-executive directors.

As with the existing Combined Code recommendations, there is no differentiation between small and large companies. However, the report does recognise that it may take more time for smaller listed companies to comply with revised Combined Code provisions.

Finally, the report recommends that, to determine the extent to which behaviour changes as a result of the proposals, the Government and the Financial Reporting Council (or its successor body) shall review progress in two years' time.

Recognising that the report already reflects a wide consultation process, it is intended that fatal flaws comments will be invited until April (though the substance of the recommendations will not be re-opened). Thereafter, a definitive version of a revised Combined Code will be issued and will come into effect in respect of accounting periods starting on or after 1 July 2003.

Key elements of the guidance are set out on the forthcoming pages.

Copies of the guidance can be obtained from: www.dti.gov.uk/cld/non_exec_review

Summary of recommendations

The board

- A description of the role of the board is proposed for incorporation into the Combined Code.
- A statement should be published in the annual report describing how the board operates. This should include the number of board and board committee meetings during the year and the attendance of individual directors.
- At least half the members of the board, excluding the chairman, should be independent non-executive directors (currently less than one third). However, there should also be a strong executive representation on the board.

The chairman

- The report describes the role of the chairman and offers guidance to increase their effectiveness.
- Critically, it is recommended that a chief executive should not become chairman of the same company.

Non-executive directors

- A definition of the role of the non-executive director is proposed for incorporation into the Combined Code and guidance is provided for non-executive directors on how to maximise their effectiveness.
- The non-executive directors should meet as a group at least once a year without the chairman or executive directors present and the annual report should include a statement on whether such meetings have occurred.
- Prior to appointment, potential new non-executive directors should carry out due diligence on the board and on the company to satisfy themselves that they have the knowledge, skills, experience and time to make a positive contribution to the board. Guidance on pre-appointment due diligence is offered.

Summary of recommendations

The senior independent director

- A senior independent non-executive director should be identified and be available to shareholders if they have concerns that have not been resolved through the normal channels with the chairman or chief executive.

Independence

- “Independent” is defined as a director who is independent in character and judgement and has no relationships or circumstances which affect his judgement. Such relationships and circumstances would include where the director is a former employee of less than five years, where the director holds cross directorships or has significant links with other directors through involvement in other company boards or bodies, and where the director has served on the board for more than 10 years.

Tenure and time commitment

- On appointment, non-executive directors should undertake that they have sufficient time to meet what is expected of them, taking into account their other commitments. If a non-executive director is offered appointments elsewhere, the chairman should be informed before any new appointment is accepted.
- The nomination committee should review the time required annually of non-executive directors. The reviews of performance should assess whether non-executive directors are devoting enough time to fulfil their duties.
- A full time executive director should not take on more than one non-executive directorship nor become chairman of a major company. No individual should chair the board of more than one major company.

Summary of recommendations

Recruitment and appointment

- A nomination committee, consisting of a majority of independent non-executive directors, should conduct the appointment process, and in consultation with the chairman, make recommendations to the board. The committee may include the chairman of the board, but should be chaired by an independent non-executive director.
- The annual report should identify the nomination committee members and chairman, and set out the activities of the nomination committee and the process used for appointments. The committee's terms of reference should be made public.
- The nomination committee should evaluate the balance of skills, knowledge and experience on the board and prepare a description of the role and capabilities required for a particular appointment.
- On appointment, non-executive directors should receive a letter setting out what is expected of them.
- The board should explain to shareholders why a candidate for appointment to the board meets the requirements of the role. Where the board has made an appointment during the year, it should explain the process by which the post was filled.
- Proposals are made to broaden the pool of candidates for non-executive director appointments. It is recommended that a small group of business leaders and others be set up to identify suitable candidates for non-executive director appointment from the non-commercial sector.
- Chairmen and chief executives should consider implementing executive development programmes to train and develop suitable individuals in their companies for future director roles.

Summary of recommendations

Induction and professional development

- A comprehensive induction programme should be provided to new non-executive directors - the report provides an induction checklist.
- The chairman should address the developmental needs of the board and help ensure resources are provided for developing and refreshing the knowledge and skills of directors.
- The performance of the board, its committees, and its members, should be evaluated annually and the annual report should state whether such performance reviews have taken place.
- The chairman should assess what information is required by the board. Non-executive directors should satisfy themselves that they have adequate information of sufficient quality to make sound judgements.
- The company secretary should be accountable to the board through the chairman on all matters relating to their duties as an officer of the company. It is good practice for the company secretary to be secretary to all board committees.

Remuneration

- The remuneration of a non-executive director should be made up of an annual director's fee, a meeting attendance fee, and an additional fee for the chairmanship of committees.
- Non-executive directors should have the opportunity to take part of their remuneration in the form of shares but should not hold options in the shares of their company. If, exceptionally, payment is made by means of options, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until one year after the non-executive director leaves the board.
- Where a company releases an employee to serve as a non-executive directors elsewhere, it should include in its remuneration policy report whether or not the employee will retain the related remuneration and, if so, its amount.

Summary of recommendations

Resignation

- Where a non-executive director has concerns about the way in which a company is being run or about a course of action proposed by the board, these should be raised with the chairman and their fellow directors. Non-executive directors should help ensure their concerns are recorded in the minutes of the board meetings if they cannot be resolved.
- On resignation, a non-executive director should inform the chairman in writing, for circulation to the board, of the reasons for resignation.

Audit and remuneration committees

- FRC guidance on audit committees is supported.
- Remuneration committees should have published terms of reference. The report offers a summary of their principal duties.
- The remuneration committee should have delegated responsibility for setting remuneration for the chairman and all executive directors. The committee should also set the level and structure of compensation for senior executives.
- The committee, and not executive management, should be responsible for appointing remuneration consultants.

Summary of recommendations

Liability

- Guidance is provided on what can reasonably be expected of a director in discharging their duties and it is recommended that the Government consider this guidance when considering criminal sanctions in the New Companies Act.
- A company should be able to indemnify a director in advance against the reasonable cost of defending proceedings from the company itself.
- Companies should supply details of the directors' and officers' insurance cover to potential non-executive directors before they are appointed.

Relationships with shareholders

- Non-executive directors should attend the Annual General Meeting (AGM) and to discuss issues that are raised in relation to their role. Institutional investors should also be expected to attend the AGM.
- The senior independent director should attend sufficient regular executive management meetings with a range of major shareholders to develop an understanding of the themes, issues and concerns of shareholders. The senior independent director should communicate these views to the non-executive directors and, as appropriate, to the board as a whole.
- Non-executive directors should consider attending meetings with major investors from time to time and should expect to attend such meetings if requested by major shareholders in the company.
- A company should state what steps it has taken to ensure that the members of the board develop a direct understanding of the views of major investors.
- On appointment, meetings should be arranged for non-executive directors to meet major investors, as part of the induction process.



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