

The Higgs Report on Non-Executive Directors

Summary Recommendations

January 2003



BOSTON · BRUSSELS · FRANKFURT · HARRISBURG · HARTFORD · LONDON · LUXEMBOURG
NEW YORK · NEWPORT BEACH · PARIS · PHILADELPHIA · PRINCETON · SAN FRANCISCO · WASHINGTON

www.dechert.com

THE HIGGS REPORT ON NON-EXECUTIVE DIRECTORS

On 20 January 2003 Derek Higgs published his “Review of the role and effectiveness of non-executive directors”, at the same time as the Financial Reporting Council’s (“FRC”) new guidance for audit committees was released (also known as Sir Robert Smith’s recommendations).

Copies of the Higgs Report (the “Review”) can be obtained from www.dti.gov.uk/cld/non_exec_review.

The Review proposes a revised Combined Code (the “Code”) which we have attached to this summary showing revisions to the previous version. The single biggest change is the new provision that at least half of the board members should be non-executive directors, which will have a major impact on board composition. However, balance is proposed as the key requirement in the composition so that boards should neither be too small nor too large and unwieldy.

The Review contains a useful summary of recommendations which have been adapted for ease of reference below.

SUMMARY OF RECOMMENDATIONS

The Board

- The board is collectively responsible for promoting the success of the company by leading and directing the company’s affairs. A description of the role of the board is proposed for incorporation into the Code.
- The number of meetings of the board and of its main committees should be stated in the annual report, together with the attendance of individual directors. A description should be included in the annual report of how the board operates, setting out which decisions are delegated to management.
- The board should be of an appropriate size. At least half the members of the board, excluding the chairman, should be independent non-executive directors. There should also be a strong executive representation on the board.

The chairman

- The chairman has a pivotal role in creating the conditions for individual director and board effectiveness. The Review describes the role of the chairman and some of the attributes and behaviours of an effective chairman. As well as ensuring an effective flow of information between shareholders and the board, appropriate board composition and board evaluation the Chairman needs to ensure sufficient time is allocated for the debate of complex or contentious issues particularly preventing the non-executives being given unrealistic deadlines for decision-making.
- The roles of chairman and chief executive should be separated and the division of responsibilities between the chairman and chief executive set out in writing and agreed by the board.
- A chief executive should not become chairman of the same company. At the time of appointment the chairman should meet the test of independence set out in the Review.

Role of the non-executive director

- A description of the role of the non-executive director is proposed for incorporation into the Code. Guidance is offered 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.

The senior independent director

The Review endorses the appointment of a senior independent director. Such appointee should be available as a means of communication between shareholders and the board.

The Code includes guidance as to what will comprise independence for the first time, for the purposes of non-executive directors.

Independent non-executive director:

A non-executive director is considered independent when the board determines that the director is independent in character and judgement, and there are no relationships or circumstances which could affect, or appear to affect, the director's judgement.

Such relationships or circumstances would include where the director:

- **is a former employee of the company or group until five years after employment, or any material connection, has ended;**
- **has, or has had within the last three years a material business relationship with the company either directly, or as 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 ten years.**

The board should identify in its annual report the non-executive directors it determines to be independent. The board should state its reasons if a director is considered independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination.

Recruitment and appointment

- There should be a nomination committee of the board to conduct the process for board appointments and make recommendations to the board.
- The nomination committee should consist of a majority of independent non-executive directors. It may include the chairman of the board, but should be chaired by an independent non-executive director. A statement should be made in the annual report setting out the composition, terms of reference, and activities of the nomination committee and the process used for appointments. A summary of the principal duties of the nomination committee is offered.
- 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. A specimen letter of appointment is set out in the Review.
- The nomination committee should provide support to the board on succession planning.

- Chairmen and chief executives should consider implementing executive development programmes to train and develop suitable individuals in their companies for future director roles.
- The board should set out to shareholders why they believe an individual should be appointed to a non-executive director role and how they meet the requirements of the role.
- Proposals are made to broaden the pool of candidates for non-executive director appointments, including more executive directors and senior executives from other companies and directors of private companies, as well as advisors and those from other backgrounds.
- A small group of business leaders and others will be set up to identify how to bring to greater prominence candidates for non-executive director appointment from the non-commercial sector.
- The Review offers guidance on the process for the appointment of a new chairman.

Induction and professional development

- A comprehensive induction programme should be provided to new non-executive directors and is the responsibility of the chairman, supported by the company secretary. The Review provides an induction checklist.
- The chairman should address the developmental needs of the board as a whole with a view to enhancing its effectiveness. Resources should be provided for developing and refreshing the knowledge and skills of directors.
- The performance of the board, its committees and its individual members, should be evaluated at least once a year. The annual report should state whether such performance reviews are taking place and how they are conducted.
- Supported by the company secretary, the chairman should assess what information is required by the board. Non-executive directors should satisfy themselves that they have appropriate information of sufficient quality to make sound judgements.
- The company secretary should be accountable to the board as a whole, through the chairman, on all governance matters.

Tenure and time commitment

- A non-executive director should normally be expected to serve two three-year terms, although a longer term will exceptionally be appropriate.
- On appointment, non-executive directors should undertake that they will 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 annually review the time required of non-executive directors. The performance evaluation 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.

Remuneration

- The remuneration of a non-executive director should be sufficient to attract and fairly compensate high quality individuals. It may comprise an annual 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.
- Non-executive directors should not hold options over shares in their company. If, exceptionally, some 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 executive director to serve as a non-executive director elsewhere, it should include in its remuneration policy report whether or not the director will retain the related remuneration and, if so, its amount.

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 ensure their concerns are recorded in the minutes of the board meetings if they cannot be resolved.
- Resignation should very much be kept as a last option, but in such event, a non-executive director should inform the chairman in writing, for circulation to the board, of the reasons for resignation.

Audit and remuneration committees

- Sir Robert Smith's recommendations on audit committees are endorsed in the Review.
- The remuneration committee should comprise at least three members, all of whom should be independent non-executive directors. It should have published terms of reference. The Review offers a summary of the principal duties of the remuneration committee.
- The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman. The committee should also set the level and structure of compensation for senior executives. The committee should be responsible for appointing remuneration consultants.
- No one non-executive director should sit on all three principal board committees (audit, nomination and remuneration) simultaneously.

Liability

- Guidance is provided for incorporation into the Code on the position of a non-executive director, which may be relevant to the determination of liability.
- The Review recommends the Lord Chancellor's Department to consider steps to promote active case management in cases applying to directors.
- The Government is recommended to consider the principles set out by the Company Law Review in considering criminal sanctions in relation to directors.
- A company should be able to indemnify a director in advance against the reasonable cost of defending proceedings from the company itself, without trying to establish in advance the prospects of success of the case.
- Companies should provide appropriate directors' and officers' insurance and supply details of their insurance cover to potential non-executive directors before they are appointed.
- The City of London Law Society and the Institute of Chartered Secretaries and Administrators (ICSA), together with the Association of British Insurers (ABI) and the British Insurance Brokers' Association (BIBA), have agreed to draw up guidance on insurance for directors for companies to use in obtaining appropriate directors' and officers' insurance.

Relationships with shareholders

- All non-executive directors, and in particular chairmen of the principal board committees, should attend the Annual General Meeting (AGM) to discuss issues that are raised in relation to their role.
- The senior independent director should attend sufficient of the regular meetings of management with a range of major shareholders to develop a balanced 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.

- Boards should recognise that non-executive directors may find it instructive to attend meetings with major investors from time to time and should be able to do so if they choose. Moreover, non-executive directors should expect to attend such meetings if requested by major investors in the company.
- On appointment, meetings should be arranged for non-executive directors with major investors, as part of the induction process.
- A company should state what steps it has taken to ensure that the members of the board, and in particular the non-executive directors, develop a balanced understanding of the views of major investors.
- The Review endorses the Government's approach to more active engagement by institutional shareholders with the companies in which they invest, and the Institutional Shareholder Committee's (ISC) code of activism. Institutional investors should attend AGMs where practicable.

Smaller listed companies

- The recommendation that no one individual should sit on all three principal board committees at the same time should not apply to smaller listed companies. With this exception, there should be no differentiation in the Code's provisions for larger and smaller companies. It may take more time for smaller listed companies to comply fully with the Code and it is recognised that some of its provisions may be less relevant or manageable for smaller companies.

Timing of changes

- Most of the recommendations are for changes to the Code. These are consolidated and shown as revisions to the previous version of the Code which we have enclosed. The Review has the aspiration that the FRC and the FSA will wish to take forward its proposals and that the resulting changes will be introduced as soon as practicably possible, preferably for reporting years starting on or after 1 July 2003.
- To determine the extent to which behaviour has changed as a result of these proposals, the Review recommended that the Government and the FRC review progress in two years' time.

This note is a basic summary of the legal issues. It should not be relied on as an authentic statement of the law. You should obtain detailed legal advice before taking action. © Dechert 2003. Reproduction of items from this document is permitted provided you acknowledge clearly Dechert as the source.

Dechert LLP in cities other than London, Paris and Luxembourg.