Non-Executive Directors

Recommended Code of Conduct for quoted companies

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ShareSoc
UK Individual Shareholders Society

FIRST FLIGHT
NON-EXECUTIVE DIRECTORS

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Foreword

The importance of having active and competent Non-Executive Directors (including Chairmen) in public companies cannot be over emphasised. They can make all the difference between the long term success or failure of a business, and are crucial when a company faces short term difficulties. This document has been written so as to encourage the raising of standards in the selection and performance of Non-Executive Directors. It provides guidance for companies, and their shareholders, on how Non-Executive Directors and independent Chairmen should be appointed and remunerated.

This is a voluntary code that First Flight and ShareSoc suggest should be followed so as to encourage best practice.

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1. Executive Summary

Capitalism around the globe is currently being questioned because some major public companies have been seen to be badly managed, with the Directors not doing their jobs competently. Much of the blame has been laid at the feet of the Non-Executive Directors for not controlling imprudent executives or not even fully understanding what companies were doing and why.

Corporate Governance lays down the framework under which company boards operate. It underpins the development of a company's strategy and the delivery of strong financial performance in an increasingly difficult environment of external scrutiny by regulators and the wider public. Independent Non-Executive Directors (including Chairmen) have a key part to play in the effective running of Boards. However if they are not truly independent, do not contribute, or do not challenge executive management when appropriate, they will be ineffective. Similarly if they have too many roles in other organisations so they cannot commit sufficient time to their duties, they are going to fail their obligations to the companies of which they are a Director.

If Companies continue to ignore the UK Corporate Governance Code, as many clearly do, they will continue to be part of these grim statistics: "*only 29% of UK companies declared their Non Execs met standards of independence*" and "*56% of companies do not feel confident of getting good performance from their Non Execs*"*. As a result they are likely to end up on the front pages of newspapers for the wrong reasons like Enron, Northern Rock, Olympus, Barclays, News Corp and others.

We are not advocates of what might be described as the old fashioned "generic" Non-Executive Director. There are too many cases of the same Non-Executives being appointed to too many Boards with the result that in many instances they fail their companies. We strongly believe in broadening the Non-Executive gene pool which produces more effective and committed Non-Executives who have sufficient time to be effective and really add value to their boards.

Our key recommendations for how to improve the performance of Non-Executive Directors are given on the following page.

** Coutts Research – See "A Good Piece Of Advice - How You Can Use Non-Executives To Unlock Value In Your Business" published by Coutts & Co.*

First Flight and ShareSoc's key recommendations for companies regarding the appointment of Non-Executive Directors are as follows:

1. All public companies should have a Nomination Committee with a minimum of three members and they should use an external search process to identify suitable Non-Executive Director candidates who should be put through a formal interview process;

2. Companies should only appoint Non-Executives who are truly independent and should ensure that all current Non-Executives on their boards comply fully with independence criteria;

3. Shareholders should have at least one representative on the Nomination Committee (as they do in Sweden) to review the list of Non-Executive candidates;

4. Chairmen and CEO of companies should be prevented from appointing their friends to their Boards;

5. Non-Executive Directors should be approved by all members of the Board and by shareholders at the AGM;

6. Companies should not generally have Non-Executives on their Board with more than 4 roles and should not consider appointing Non-Executives who have more than 3 other roles;

7. All Non-Executives should be subject to an annual election by shareholders at the AGM and should not remain on the Board for more than nine years.

8. Nomination Committees should look at the overall Board composition and when proposing new Non-Executive Directors they should ensure significant weight is given to relevant skills, whether they contribute to diversity, their intrinsic personal qualities and their underlying competencies. Proven prior career experience as a board Director should not be the sole or prerequisite criteria so as to expand the pool of candidates; the objective should be to ask: "what skills does the Board require?" not "who do we want on the Board?";

9. Non-Executive Director fees should be commensurate with the obligations now imposed on them and the time commitment required so as to encourage more professionalism in the role;

10. Companies should remunerate their Non Execs with a combination of fees, shares and share options which are appropriate to the size and nature of the company.

Further explanation of these recommendations is supplied below.

2. Introduction

Shareholders provide the business sector with risk capital but they also contribute to the efficiency and dynamism of individual companies exercising influence over the strategy of companies – this is typically termed "engagement". Active shareholder participation promotes a healthy balance of power between owners and the Board of Directors.

There are four main Board tasks: a) policy formulation; b) strategic thinking; c) supervision of management and d) ensuring accountability.

The Non-Executive Directors are there to ensure that a Board fulfils its statutory duties to the company, the legislators, the regulators and the stakeholders including shareholders. They have a crucial role to play in Board performance; they bring complementary skills to those that exist within the Executives on the Board and they must fully understand the issues faced by the Company, provide outside objectivity, challenge the Executive and ensure healthy debate on key issues.

In the USA Non-Executives are called Independent Directors which is 100% what they should be. If they are not, they will be ineffective. Sadly in the UK cronyism is still rife in the appointment of Non-Executives and according to recent research only 29% of UK companies declared their Non Execs met standards of independence; it is hard to see how a Non Exec can be truly effective if they are not independent and this probably accounts for the depressing statistics that: "*56% of UK companies don't feel confident of getting good performance from their Non Execs*" and "*33% of companies experienced poorly performing NEDs*" (Coutts research).

Perhaps this is not surprising considering these findings:

1. "Networking (89%) and business referrals (88%) are the selection routes of choice for companies" (Coutts);
2. "Most NEDs are appointed through personal contacts" (from the Opus Executive Partners report entitled "How's Mine Doing: A Review of Boards, Performance and Risk in the Mining Sector 2011");
3. "Only 4% of NEDs are interviewed formally" (Opus report mentioned above);

This is of major concern. Companies are clearly not adhering to the procedures set out in the UK Corporate Governance Code for the appointment of new directors and consequently the wrong Non-Executives are being appointed. As a result, a large number are not performing well. Shareholders should be playing a greater role in ensuring that the Non-Executives being considered for their Boards meet independence criteria, bring the required skills/competencies and are effective.

The Cass Business School's "Roads to Ruin" report on 20 major corporate failures such as RBS, BP, Railtrack, Airbus, Northern Rock, AIG, Enron, etc, found common themes including interestingly in all cases that there was: "*an inability of the Non Execs to exercise influence or control*".

There are four main reasons for poorly performing Non Execs in the UK:

1. Many are appointed without going through a proper interview process, very often because they are well known to the Chairman or CEO;
2. Many do not comply with the "truly independent" criteria;
3. Many are clones and are "more of the same" meaning many Boards have a distinct lack of diversity on them;
4. A high percentage of Non-Executives have too many roles to be effective.

Changes are urgently required and shareholders are in a good position to ensure that companies improve their Corporate Governance and ensure that the selection and appointment of Non-Executives adheres to the UK Corporate Governance Code.

3. The UK Corporate Governance Code

The UK Corporate Governance Code has a number of provisions to encourage companies to facilitate effective, entrepreneurial and prudent management that can deliver the long term success of the company. The first version of the Code was produced in 1992 by the Cadbury Committee; its paragraph 2.5 is still the classic definition of good Corporate Governance:

"***Boards of Directors are responsible for the Governance of their Companies. The shareholders' role in Governance is to appoint the Directors and Auditors and to satisfy themselves that an appropriate Governance structure is in place. The responsibilities of the Board include setting the Company's strategic aims, providing the leadership to put them into effect, supervising the Management of the business and reporting to shareholders on their stewardship. The Board's actions are subject to laws, regulations and the shareholders in general meeting***."

The main principles of the Code include:

Section A: Leadership:

1. Every Company should be headed by an effective Board which is collectively responsible for the long-term success of the Company.

2. As part of their role as members of a unitary Board, Non-Executive Directors should constructively challenge and help develop proposals on strategy.

Section B: Effectiveness:

1. The Board and its Committees should have the appropriate balance of skills, experience, independence and knowledge of the Company to enable them to discharge their respective duties and responsibilities effectively.

2. There should be a formal, rigorous and transparent procedure for the appointment of new Directors (including Non-Executives) to the Board.

3. All Directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.

4. The Board should undertake a formal and rigorous annual evaluation of its own performance and that of its Committees and individual Directors.

5. All Directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.

Re 1. above; there are numerous examples of Boards not having all the necessary skills they require to operate effectively.

Re 2; most NEDs are still appointed through personal contacts (88%).

Re 3; many Non Execs have too many roles (10% have 10 or more) to contribute effectively.

Re 4; many Boards do not carry out "formal and rigorous" Board Evaluations.

Re 5; many Directors are not being submitted for re-election and the shareholders are paying little attention to whether or not they have performed.

Non-Executive Directors have responsibilities in the following areas:

- **Strategy:** Non Execs should constructively challenge and contribute to the development of strategy.
- **Performance:** Non Execs should scrutinise the performance of management in meeting agreed goals and objectives and monitoring.
- **Risk:** Non Execs should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.

- **People:** Non Execs are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning.

Non-Executive Directors are the custodians of the governance process. They are not involved in the day-to-day running of business but monitor the executive activity and contribute to the development of strategy.

The UK Corporate Governance Code is a "comply or explain" approach which claims to be strongly supported by both companies and shareholders. However evidence and research indicates that bearing in mind the five principles listed above under "Effectiveness", a large number of companies are failing to adhere to all of them which has resulted in a number of corporate disasters, some reviewed by Cass Business School's report like the failures at Enron, Northern Rock, AIG, BP and RBS etc and more recently at Olympus, News Corp and Barclays.

Major improvements are required in the way companies and their Boards operate and shareholders should be more demanding of their companies to ensure their basic adherence to the UK Corporate Governance Code and best practise.

First Flight/ShareSoc recommendations:

- The UK Corporate Governance Code is frequently not being adhered to with regard to the selection and appointment of Non-Executive Directors – many Non Execs are being appointed through personal contacts of existing Board members (usually by the Chairman) – this should be discouraged by the Nomination Committee and shareholders;
- The Annual Report should state how many other roles their Non-Executives have and the same with potential Non-Executives;
- Boards should not have Non-Executives who have more than 4 roles as they will have insufficient time to understand the business and contribute effectively, unless those roles are on the boards of organisations that meet infrequently or where their duties are not onerous;
- Companies should aim to have Boards with Directors from diverse backgrounds including gender and a balance of skills covering all aspects of the company's activities and its stakeholders;
- All Non-Executives should be subject to an annual election by shareholders at the AGM and should not remain on the Board for more than nine years (and preferably less) unless there is a very good and specific justification supplied.

Note regarding AIM companies: Although the UK Corporate Governance Code does not technically apply to AIM companies, we suggest that they should adhere to the obligations of the Code unless there are very good reasons to do otherwise. It is particularly important in AIM companies, who are often dominated by shareholder insiders, that there are adequate numbers of independent Non-Executive Directors. According to a recent survey of AIM companies undertaken by First Flight, the average length of service for Non-Executives is 7 years in Media companies, 10 years in IT companies and 10 years in Mobile companies. This clearly shows that there is insufficient turnover of Non-Executives in AIM companies and many are unlikely to be independent.

4. Nomination Committees

The sole task of a Company's Nomination Committee, who should have at least three members, is to evaluate and propose the appointments (and fees) of Directors including Non-Executives to the shareholders at the AGM.

The Nomination Committee should be independent of the company's Board of Directors and candidates for election to the Board including Non-Executives should be proposed by the Nomination Committee to the shareholders at the AGM.

The Nomination Committee should actively seek to represent the views of shareholders in general, and should ensure that its recommendations are endorsed by the largest shareholders and not just the Board of Directors.

We would like to see the UK follow the example of the Scandinavian Code on Corporate Governance which states that at least one member of the Nomination Committee should be a shareholder or investor that reviews the list of Non-Executive candidates so that the Chairman of a company cannot dictate, or excessively influence, who is appointed to the Board.

The Swedish Corporate Governance Code encourages strong "ownership" powers in the Nomination Committee whose members are approved by shareholders and we support this concept.

Nomination Committees should ensure that the proper process is adhered to in the appointment of Non-Executives which must include: external search and formal interviews of all candidates. Evidence indicates that many Company's Nomination Committees are fairly ineffective, widely accepted as the weakest Committee and that the Chairman, CEO and sometimes the Board itself make the decisions on new appointments rather than the Nomination Committee.

Provision B.2.4 of the UK Corporate Governance Code states: "*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. This section should include a description of the board's policy on diversity, including gender, any measurable objectives that it has set for implementing the policy, and progress on achieving the objectives. 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. Where an external search consultancy has been used, it should be identified in the annual report and a statement made as to whether it has any other connection with the company*".

The appointment process of Non-Executives on UK Boards has been criticised as a flawed process. Evidence indicates that many Nomination Committees fail to carry out a formal and professional assessment of potential Non-Execs: according to Opus: "*only 4% of NEDs are interviewed formally*" - this is of major concern and urgently needs to be addressed.

Surprisingly not all UK quoted companies have Nomination Committees and when they do they are frequently approving the appointment of Non-Executives who clearly do not comply with the UK Corporate Governance Code's "independence" criteria due to the domination of the selection process by the "old boy network".

There is plenty of evidence that Boards often fail to define the criteria for the role of their Non-Execs as did BP and many others because they focus on "who they want on their Board" not what skills they require.

Search firms should be playing a significant role in defining the criteria and the required skills but looking at many Boards, in many cases they are not very successful at this either because they are focused on a narrow and highly visible pool of Non-Execs or they pay more attention to the prestige of the organisations in which these candidates hold or have held roles, rather than their actual performance in the roles.

Non-Execs should not remain on the Board for more than nine years, and preferably less, so as to retain their independence and should be subject to an annual election by shareholders at the AGM.

The Nomination Committee should post onto the Company's web site the candidates they are nominating for election or re-election with the following information:

- The name, age, education, work experience and core skills of the candidates (assessed according to the FSA's 6 core competencies – see under Diversity);
- Any work they have performed for the company and/or any professional or business connections they have with the company;
- Any holdings of shares owned by the candidate or his/her legal vehicles;
- Where the company sourced the candidate from and how many candidates have been interviewed for the role;
- How many other roles the potential candidates have;
- Whether the candidate complies 100% with the UK Corporate Governance Code "independence" criteria and whether the candidate knows personally or professionally any of the Directors including the Chairman and to what extent;
- In the case of re-election, the year the Non-Executive was first elected.

At the AGM the Nomination Committee should give an account of how it has conducted its work and explain why it is proposing the candidate(s). A Non-Executive candidate should not be formally appointed until approved by shareholders at the AGM.

First Flight/ShareSoc recommendations regarding Nominations:

- All companies should have a Nomination Committee with a minimum of three members, who will use external Search to identify suitable Non-Executive candidates who will then be put through a formal interview process;

- Shareholders should have at least one representative on the Nomination Committee (as they do in Sweden) to review the list of Non-Exec candidates of a company so that a company Chairman cannot dictate, or excessively influence, who is appointed to the Board;

- When Companies require Non Execs the Nomination Committee should look at the overall Board composition and ensure significant weight is given to relevant skills, diversity and intrinsic personal qualities and underlying competencies, not just proven prior career experience in order to extend the pool of candidates; the objective should be to ask: "what skills does the Board require?" not "who do we want on the Board?";

- Companies and their Nomination Committees should make the appointment process for Non-Execs more transparent and show evidence of using an external Search firm or advertising of the role, creating proper short lists of candidates who will have been formally interviewed and assessed for what skills they bring to the Board and not who they are;

- Potential Non-Execs should be formally proposed by the Nomination Committee at the company's AGM (not announced as having already been appointed) and the Annual report should state how they have been sourced, what skills and competencies they bring to the Board and how many other roles they hold;

- Once a new Non-Exec is appointed, the Chairman and Nomination Committee must ensure that they are provided with a formal and comprehensive induction; this should include an introduction to all key managers, visiting company sites, customers, suppliers and shareholders and access to any business plans, Board Evaluations, previous Board papers etc. Attending a Non-Executive Director Training Course may also be beneficial;

- All Non-Execs should be subject to an annual election by shareholders at the AGM and should not remain on the Board for more than nine years, and preferably less, so as to retain their independence.

5. Independence of Non-Executive Directors

Non-Executive Directors are viewed as the "custodians of the Governance process" and all such Directors are expected to have a strong, independent minded character.

The Higgs Report in 2003 made the following comment:
"*Although Non-Executive Directors need to establish close relationships with Executives and be well informed, all Non-Execs need to be independent of mind and willing and able to challenge, question and speak up. All Non Execs need to be independent in this sense*."

The Higgs report identified other personal characteristics for Non Execs which are linked to an independence of mind:

- Integrity and high ethical standards.
- Sound judgement.
- An ability and willingness to challenge and probe. Within the "collegiate" environment of a unitary Board, Non Execs must have the strength of character to obtain full and satisfactory answers to their questions.
- Strong interpersonal skills. The effectiveness of a Non-Executive Director depends on exercising influence whilst not giving orders. To exercise influence, a NED must have the trust of his or her colleagues.

The independence of a Non-Exec should be agreed by the rest of the Board. If the Non-Exec is being proposed because he or she is a friend of the Chairman or CEO then they do not satisfy the independence criteria and it is hard to see how such a Non Exec can be truly effective.

The Board is also required by the UK Corporate Governance Code to identify in each annual report the Non-Execs that it has identified as independent. The Board will decide that a Director is independent:

- If he or she is independent in character and in judgement; and
- If there are no relationships or circumstances that might possibly create a conflict of interest and affect the Non-Executive Director's judgement.

The UK Corporate Governance Code sets out guidelines on how this independence must be determined and maintained. It is useful for Non-Executive Directors to be aware of the code, knowing that they must not:

1. Have been an employee of the company in the last 5 years.
2. Have had a material business interest in the company for the last 3 years.
3. Receive income or remuneration other than Director fees.
4. Participate in the company's share option/performance related remuneration or pension scheme.
5. Have close family ties with company advisers, Directors or senior employees.
6. Have conflicting cross directorships or have significant links with other Directors of the Company through involvement in other Companies or bodies.
7. Represent significant shareholders.
8. Serve as a Non-Executive Director for more than 9 years with the same company (on the basis that a Non Exec's independence will erode over time).

We would like to see the word "family" removed from clause 5 above as past friendships or business associations also prejudice independence.

The following research confirms that "cronyism" is still widespread in Corporate UK which explains why so few Non Execs pass the "independence" criteria:

- Coutts research found that: "*Networking (89%) and business referrals (88%) are the selection routes of choice for companies when appointing Non Execs*".

- And Opus research states that: "*Most NEDs are appointed through personal contacts*".

Opus research finds: "*Shockingly [their words] only 29% of companies declared their Non Execs met standards of independence*". Independent Non-Executive Directors are the cornerstone of effective Boards but with only 29% of Boards able to declare their Non-Executive Directors as being independent, this indicates a fundamental failure of many UK Boards.

The US has recently passed legislation (the Dodd-Frank law) which amongst other things is intended to ensure that their Non-Execs have to be truly independent of the Chief Executive and Chairman making it "*more difficult for Chief Execs and Chairmen to create a Board of Directors from their Country Clubs*".

The UK Corporate Governance Code has as Provision B.2.4: "*An explanation should be given if neither an external search company nor open advertising has been used in the appointment of a Chairman or Non-Exec.*" This does not go far enough in preventing companies appointing Non-Executive Directors who are not independent.

Note: Smaller or AIM companies may complain that they cannot justify the £45-50k minimum that major London Search firms charge for a Non-Executive project. But smaller search firms can do it for much less. Ineffective Non-Executive Directors result in ineffective Boards which can be enormously expensive and sadly we see far too many examples of this.

Investment Trusts: individuals who are linked in any way to the fund manager of an investment trust should not be on the Board of the trust. Neither should an individual serve on more than one company Board with a common fund manager. City of London Investment Group give further recommendations in their Corporate Governance Guide on the issues at such companies which are well worth following – see www.citlon.co.uk/reg_reports/Corp_Governance.pdf

First Flight/ShareSoc recommendations:

- Companies should only appoint Non-Executive Directors who are truly independent and should ensure that the Non-Execs they have comply fully with independence criteria;

- Companies should use external search or open advertising to identify their Non-Execs and not rely on their Boards or their Chairman to recommend appointments;

- Chairman and CEOs should be prevented from appointing their friends to their Boards.

6. Non-Executive Directors – how many roles should they have?

Being a Non-Executive Director is a proper job with fiduciary duties. It is no longer an optional extra to fit in when you can. A rule of thumb is that it now takes 1 ½ days a week to fully carry out these duties in a public company. This horrifies many Non-Execs who sometimes feel that they can find time to read the Board papers on their way to a Board meeting and the idea that they should do homework and other duties is unacceptable – in that case they should not be on the Board and the companies who are thinking of appointing them should think again. This may seem harsh but the law states that once you have signed the statutory forms to register as a Director you are on duty 24 hours a day, seven days a week. You are not a Director just when you enter the Boardroom.

The financial crisis and the "shareholder spring" have highlighted the need for the Boards of companies to have more effective Non-Executive Directors who will spend much more time on their responsibilities than they used to. It is now a much more demanding brief in areas such as risk, finance and technology and it is clear that the days of the gifted amateur Non-Exec should be behind us.

Individuals working as Non-Executive Directors should be taking on fewer Directorships and spending much more time on the roles they have.

KPMG say they see a noticeable fall-off of performance on the 3rd and subsequent role for Non-Execs. However we are still seeing many Non-Execs with far too many roles – 10% of Non Execs in the UK have 10 roles or more making it nigh on impossible for them to contribute effectively to the Boards on which they sit. The recent resignation of Non-Exec Alison Carnwath from the Barclays Board is an example; she said she was resigning because she didn't have sufficient time as she has 8 top line Non-Executive roles; this is a good enough reason to resign but more importantly begs the question why she took on so many roles in the first place and why did some of the companies take her on knowing that she had so many other commitments? It is high time companies, their Search firms and the Non-Execs themselves realise that 3 to 4 Non-Executive roles in major companies are now the maximum that they can handle or in which they can be properly informed and be truly effective.

The Walker report recommended that Non-Executive Directors should not have more than five roles and First Flight does not put forward Non-Execs who have more than 4 roles; however companies seem to be attracted to Non-Execs who have multiple roles on the basis that they "must be good" even though they are told that such Non-Execs are unlikely to add value to their Board because they simply will not have sufficient time to be well enough informed and effective.

Baroness Howe recently said: "*I would limit the number of Non-Executive positions that can be held by any individual at one time. If there's a crisis you need to drop everything and focus on sorting out the situation. But you can't do this if you owe multiple boards your time*." We strongly endorse Baroness Howe's comment.

It should be the responsibility of both the Chairman and Company Secretary to monitor not only the performance but the attendance of Non-Executive Directors at Board Meetings.

First Flight/ShareSoc recommendations:

- Companies should not have Non-Executive Directors on their Board with more than 4 roles and their Nomination Committees should not consider Non-Execs who have more than 3 existing roles;
- Companies should monitor how many other roles their Non-Execs have and should not allow them to have more than 4 roles;
- Companies should also take into account any other significant business activities or involvement in charitable/non-profit organisations in addition to directorship of Ltd or Plc companies.

7. Board Diversity

Cranfield University's School of Management 2012 report on Gender Diversity on Boards key finding is: "*The Board appointment process remains opaque and subjective, and typically driven by a corporate elite of predominantly male Chairmen who tend to favour those with similar characteristics to themselves*".

The UK Corporate Governance Code (Supporting Principle B.2) states: "*The Search for Board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the Board, including gender*".

The Higgs Review and Tyson Report in 2003 both called for more diversity in the talent pools from which Non Execs are recruited, acknowledging that the majority of Non-Executive Director appointments are made informally through personal contacts. The 2003 Corporate Governance Code made clear recommendations for a rigorous, fair and open appointment process, to promote meritocracy in the Boardroom and ultimately to raise the standard of Corporate Governance – in 2012 it is fair to say that, at best, progress is slow.

Looking at UK quoted company Boards it is not unreasonable to conclude that a majority of Chairmen don't feel comfortable with diversity on their Boards. We see the same names on multiple Boards and there seems to be a tendency to clone and ensure a lack of diversity which results in an inability to think and debate policy and strategy from different viewpoints. In other words, too many of the same types of people – similar in age, sex, ethnic, educational and social background, professional training and so on – the male, pale and stale syndrome reduces the ability of the Board to question the working assumptions and the sources and validity of information about the changing internal and external environments on which the Board is working. The Davies report in 2011 which examined the business case for gender diversity and the obstacles faced by women in seeking to get onto Boards has increased the number of women on Boards in the UK but it is easy to conclude that the report embarrassed Companies to increase gender diversity rather than seeing them embrace it because it has been shown to improve company performance.

The Davies Report suggests there is a business case for having more gender balanced Boards stating: "*companies with more women on their Boards were found to outperform their rivals with a 42% higher return in sales, 66% higher return on invested capital and 53% higher return on equity*."

Boards (and the major Search firms) are slowly realising that the traditional old fashioned "generic" Non-Executives are not providing what company Boards require of them – what they have been providing is more of the same: male, pale and stale Non Execs with little or no diversity. There is a growing need to introduce a variety of types of Non Exec – diversity not just in gender but also in background, ethnicity, experience and most importantly, those who are truly independent and have outside objectivity. An example of the problem is that there are many capable women who could contribute well to a Board with their breadth of experience but as they haven't had a traditional corporate career they get overlooked.

Less roles per Non-Executive Director requires a broadening of the Non-Exec gene pool and we are starting to see major Search firms being forced to look at potential Non-Exec candidates outside of their existing network – this is long overdue and will help professionalise the role of the Non-Exec as well as create more diversity in the Boardroom.

First Flight talks to many candidates who have potential as Non-Executive Directors and who have been to major Search Firms only to be told that: "*we can't put you forward for Non Exec roles if you haven't been a Non Exec*" – urgent changes of attitude and approach are required and firms must stop asking: "who do we want on our Board?" instead they should be asking: "what skills do we need on our Board to complement the skills we already have and bring in the skills that we don't have?"

BP, as assessed in the Cass report, is an example of a major company who suffered because of poorly performing Non-Executive Directors. The BP Board was not a balanced one due to a dominant CEO, ineffective Non-Execs who had been in place for a decade and so no longer regarded as independent, and there was a lack of diversity not just in gender but in skills and experience. The US regulator following the Texas City Refinery fire recommended that BP appoint a Non-Exec with specific expertise in refinery operations and process safety since no one on the Board had any refining experience and no one on the Board had any safety experience – this was a major omission with disastrous consequences. If BP could get it so wrong many other companies can and unfortunately do.

Non-Executives are an excellent way to add different skills, backgrounds and experience that a Board does not currently have but only with an enlightened Chairman is in place.

In 2003 Norway passed a compulsory quota law requiring a minimum of 40% of Board members to be of either sex on quoted company Boards; the law passed into action in 2006. Similarly in South Africa the Black Economic Empowerment Law requires 40% black ownership of South African private companies and consequently 40% black Directors on Boards. Two problems have emerged: firstly the pool of suitable talent dried up quickly and secondly the suitable people became overextended so creating another elite group. It now takes a minimum of 1 ½ days a week to fulfil the role of a Non-Exec in a single company, meaning Non-Execs can only handle 4 roles effectively. But the result has been that many of these new elites in Norway and South Africa hold down ten and even 30 roles! This is why we do not support a specific quota system.

John Argenti's book Corporate Collapse demonstrated that if too many of the same sort of people – same age, sex, educational background, professional background, social background, etc – came together at the top of an organisation for any length of time, it was a danger signal of corporate collapse.

Most major Search firms have only had access to potential Non-Execs who have been Directors of FTSE companies so they have been swimming in a very small pool. In addition to advocating a broader gene pool for Non-Execs, we strongly advocate the representation of stakeholders on Boards. Mothercare is an example of how this does not always happen – almost all of their customers are women and yet they only have one woman Director on a Board of ten. Their mission statement is: "*to meet the needs and aspirations of parents for their children worldwide*" – one might ask how they can achieve this when they are so woefully under represented by their customers?

We do not support the call for quotas but do support the call for a more enlightened approach to appointing Non-Executive Directors and a move away from the "who do we want on the Board" to "what do we need?" - this approach opens the door for greater diversity and a more "skills based" approach. Seventy-five percent of products and services are bought by women so why would you not want to have representatives of your customers on your Board?

Many UK Plc Chairman clearly still feel more comfortable with their own kind on their Board, but a Board should be a dynamic and enlightened organism not a clubby once a month meeting. Historically there has been a tendency for Non-Execs to be told to: "turn up and shut up" and "don't rock the boat" – however effective Non Execs are there to "rock the boat" not tip it over but certainly to rock it.

First Flight recommends Boards should have at least one, ideally two Directors with each of these four core skills:

- Strategy - *the big picture* looking to challenge and shape the future;
- Operations – *the detail* looking to make sure actions and plans are consistent with the strategy and will deliver the required performance;

- Drive – *the accelerator* and entrepreneurial abilities to drive the organisation forward and overcome obstacles;
- Monitoring Risk – *the brake* and Governance to be able to identify risk areas and issues and stop the organisation doing the wrong things.

These four areas reflect four separate and independent dimensions of board dynamics and they form two opposing pairs in terms of interaction: strategy-operations and drive-monitor and each of these core skills should be provided to the Board by its Directors. Boards that are well represented with each of these skills will be more effective.

Every Board also needs the right balance of types or categories of people to operate effectively and one of the simplest ways to categorise people was developed by David Kolb who categorised people in four ways: activist, pragmatist, theorist and reflector. True for business, and also true for learning how to ride a bike.

- The Activist – tests by trying (and failing, and hopefully learning).
- The Pragmatist – tests implications: copies, improves.
- The Theorist – forms abstract concepts. Natural planner.
- The Reflector – observes and reflects and asks why/why not?

Another choice to evaluate character is psychometric testing which can be very useful in assessing Directors and a method called Personality Profile Analysis which is suited to Board discussions has been developed by Thomas International with DISC:

- Dominance; Influence; Steadiness; Compliance.

An alternative valuable assessment tool which can be deployed is EQ-i (Emotional Quotient Inventory). Boasting a 20 year track record of research and success, an EQ-i test is a psychometric profile which shows what somebody is like to live and work with. The test scores an individual in 5 key areas: Self Perception, Self Expression, Interpersonal, Decision Making and Stress Management. Essential prerequisites for an effective Non-Executive Director are independence of thought, an ability to communicate effectively and an ability to relate to the operating environment. An EQ-i test will identify very clearly whether or not a candidate has these attributes. An EQ-i test will also help to identify candidates whose personality and mindset is not appropriate for a Non-Executive Directorship role".

It is preferable if existing Board members are profiled as well as the incoming candidate and gaps identified and filled.

The FSA lists (CP/10/3) six core competencies that Boards should have as follows:

1. Strategic Management
2. Risk Management
3. Market Knowledge
4. Governance
5. Financial Management
6. Regulation

A balanced Board should have a mix of all these skills and all types of people (diversity) to enable healthy debate. Additional characteristics of good Non-Execs are: common sense, persistence, competence, independence of mind (as outlined above) but most importantly a Board needs a balance of different types of Non-Executive Directors.

With a Non-Exec project, First Flight likes to understand the current balance of the Board in terms of skills, diversity and personalities so that we can make sure that the addition of an incoming Non-Exec will enable the Board to operate effectively and "the whole being greater than the sum of the parts".

The HR department should have up-to-date CVs for each Director, a job description and an annual assessment for both Executive and Non-Executive Directors to enable the company's annual evaluation to assess the Board overall for its capabilities and any shortcomings.

Note though that diversity for the sake of it is opposed if it leads to a Board with too "generic" a background. It is important for Board Directors to have some knowledge of the market sector in which the company operates although Non-Executive Directors should "never be frightened of asking what might appear to be a dumb question" as Sir Harry Solomon of Hillsdown Holdings said. Being close to a sector can sometimes prevent this.

First Flight/ShareSoc recommendations:

- Companies should aim to have Boards with Directors from diverse backgrounds including gender and a balance of skills covering all aspects of the company's activities and its stakeholders;
- Boards should do regular evaluations on what core skills and competencies their company requires to operate effectively;
- Boards should strive to achieve diversity of age, sex, ethnicity, educational and social background, skills, professional training and so on – to move away from the male, pale and stale syndrome;
- Potential Non Execs should be assessed for "what skills they bring to the Boardroom" rather than "who they are".

8. Board Evaluations

The UK Corporate Governance Code provision B.6 main principle recommends:
"*The Board should undertake a formal and rigorous annual evaluation of its own performance and that of its Committees and individual Directors*".

An external evaluation should provide a fresh perspective and provide clarity of purpose, more productive Board meetings, more effective decision making, better personal relationships and appreciation of individual roles, leading to a more collaborative approach within the Board and with internal and external stakeholders. It will also provide better succession planning and clarity with on-going recruitment.

Supporting principle of the Code:
"*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 member be appointed to the Board or seeking the resignation of Directors. 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)."*

Code Provision B.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*".

Code Provision B.6.3: "*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 the Executive Directors*."

The performance evaluation should include both a skills/competencies evaluation and a behavioural assessment.

We recommend that the evaluation should be carried out externally by a specialist Board Evaluation firm and not carried out by an Auditor nor a Search firm as they will both be conflicted.

Cranfield's recent report on "Gender Diversity On Boards" said Non-Exec candidates should be assessed "*not only on their suitability for the role in terms of their skills and who they worked for but also on the basis of subjective elements such as personality, values and chemistry*". They criticised Boards (and their Search firms) with regard to the way Non-Execs are appointed, for frequently starting with the question: "*who do we want as a Non-Exec rather than what do we need?*". The fundamental questions for Boards to address are: what are the core skills, different backgrounds and viewpoints (diversity) that we need around our Boardroom table to cover all the issues that confront us as a company and enable us to debate constructively and not have a Boardroom of all like minded people?

An assessment should also be done on how well prepared each Non-Executive Director is, whether they have read the Board papers and whether they have the time to understand the business and contribute. The financial crisis and the "shareholder spring" have highlighted the need for Non-Executives to spend much more time on their responsibilities which require them to have fewer roles. This will enable the role of a Non-Executive Director to evolve and become more professional.

First Flight/ShareSoc recommendations:

- Companies should carry out an annual Board evaluation – these should be externally carried out and not by a Search firm or their Auditor who are conflicted;

- Major shareholders should be invited for their input and the evaluation should be included in the Annual Report with time allocated at the AGM to discuss its findings.

9. Non-Executive Remuneration

All Boards should establish a Remuneration Committee of at least two (smaller companies) or three (for larger companies) Non-Executive Directors whose main tasks is to "consult the Chairman and/or Chief Executive about their proposals relating to the remuneration of the Executive Directors including pension rights". The Chairman may be a member but should not Chair the Committee.

The level of pay for Executives should be linked to performance and shareholders should be consulted and approve remuneration packages.

The level of pay of Non-Executive Directors should reflect:

- His/her track record and ability to command a rate of remuneration in the market place.
- How much he/she is paid in their other roles in other companies.
- The role and contribution he/she is expected to make and the value this will add to the company.
- The time commitment.
- The amount that the Chairman and other NEDs are paid.
- The amount Executive Directors are paid and how this compares on a per day basis.
- Shareholders views about what is acceptable.
- Market data for rates of pay for NEDs in similar companies.

Types of remuneration structure

The most usual practice for quoted companies is that the Non Exec is paid a fixed fee and in some cases some of the fee is paid in shares. The remuneration and types of remuneration structure should reflect the time and nature of the desired role and are usually similar to those of the Chairman, i.e.:

i. Paid only fees (monthly)
ii. Paid a mixture of fees in cash and in shares
iii. Awarded a number of shares on appointment which vest at a rate of x% per year, plus an annual fee.
iv. Awarded a number of options on appointment plus an annual fee.
v. An annual fee, plus annual awards of options or LTIPs or other types of share awards.

NEDs need to be seen as independent of the company and therefore receive fees, not a salary. Pluralist Non-Executives with several directorships will often have set up a service company to which these fees are paid gross.

Non Execs should have their fees paid via the company payroll with National Insurance and tax deducted, unless their fees are paid to a company, but they are still being paid fees, not a salary.

Chairman and Non Execs will have a letter of appointment, of which 10% are for one year, 8% are for two years and 80% are for three years.

A NED is always entitled to resign immediately if he or she has a disagreement with the Board or feels there is a point of principle involved; in fact they should be encouraged to do so and they should require their reasons to be minuted.

The UK Corporate Governance Code Guidance on Remuneration:

Code Provision D.1.3:

- *Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options or other performance-related elements. 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 B.1.1)), as required for UK incorporated companies under the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008.*

D.2 Procedure Main Principle:

- *No director should be involved in deciding his or her own remuneration.*

Code Provision D.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.*

The Quoted Company Alliance (QCA) has produced useful guidance on fees for NEDs:

- The result of increasing demands on Non-Executives may lead to higher fees. Payment either partly or fully in shares, held during the Director's term of office and for a significant period afterwards sends a good signal about the alignment of the Director's interests to those of shareholders.
- On the rare occasion Non-Executive Directors participate in performance related remuneration, investors should be consulted and their support obtained.

This is more useful and less restrictive than the ABI and NAPF guidance. The UK Corporate Governance Code is therefore strongly against awarding options to Non Execs and requires prior approval of any award of options.

First Flight and ShareSoc feel that the Code may be appropriate for large companies, but that more flexibility should be permitted for smaller companies, particularly those in an early stage of development. We support the position given in the QCA's Guidelines for Smaller Quoted Companies which states that a Non-Executive Director may not be independent if he/she has a "*significant* participation in the company's share option or performance-related-pay scheme". The question being the size of the options - as it is only when they become excessive that they might lead to a Non Exec behaving in a way that may not be in the company's best long-term interests. However being able to offer options can help smaller, start-up and fast growth companies to keep costs down and still enable them to attract high-calibre and interested Non-Executive Directors. Share options should only be used in such companies, should be limited in size and should be subject to specific shareholder approval (as indicated in the QCA guidelines). Any such options that are granted should not be valued at more than 200% of the typical fixed fee of a non-executive director and should only replace a part of that fee (not be additional).

Time commitment:
The role of the Non Execs has changed significantly. In the 1980s, most British boards were primarily made up of insiders. Robert Boothby, a former Conservative Member of Parliament, described what being a Non Exec was like in that era: "No effort of any kind is called for. You go to a meeting once a month, in a car supplied by the company, you look grave and sage, on two occasions say 'I agree,' say 'I don't think so' once, and if all goes well you get £500 a year." He added, "If you have five of them, it is total heaven, like having a permanent hot bath."

In 1991, the median time spent was 17 days per company, when Tiny Rowland notoriously compared Non Execs to trinkets on Christmas trees, many Boards would have a Knight and a Lord and Board meetings were amiable affairs often followed by a good lunch.

The role today is much more professional; Non Execs must challenge and to do so they must gain a detailed understanding of the company. They must be rigorous, persistent and committed. So it is not surprising that the time commitment has nearly doubled to 31 days per year per company.

- The average time commitment for a Chairman has increased since the Walker report to 3-4 days per week for FTSE 100 companies due to the growing complexity of the role plus the number of sub-committees such as Audit, Nomination, Remuneration, Risk and Strategy committees. The role of the Chairman of large companies is significantly different to that of a smaller company, where the main focus is on running the Board meetings.
- The average time commitment for a Non-Exec is 24-30 days p.a., again increasing for larger companies.
- Board meetings, including preparation, tend to take up about 40% of the time, with strategy and planning meetings taking 10% and sub-committees 20%.

Remuneration Levels

We have not provided information on existing levels of cash remuneration for non-executive directors, nor recommendations on what is appropriate, in this document. Please contact First Flight if you need further information on the current levels or advice on what should be paid.

Payment in shares or options

At the time of writing:

- 15% of Chairmen and 10% of Non-Execs receive part of their fees in shares.
- The prevalence of share options in AIM-listed companies is high with around half of Non-Execs benefitting.
- The UK Corporate Governance Code states that the remuneration for Non Execs should not include share options however it should be noted that AIM listed companies are not covered by the UK Corporate Governance Code although they will be subject to UK listing requirements.

Data from MM&K (see " Life in the Boardroom - 2012 Chairman and Non-Executive Director Survey") shows about 20% of UK quoted companies include options in Non Exec remuneration. Where options are awarded, they can be very significant. The survey also confirms that options in private and AIM listed companies are a key component of reward in many cases.

MM&K data also shows that 17% of companies are paying Non Execs in shares (as opposed to options), but when they do the amounts are typically quite substantial - about half of the total. Not surprisingly, option holding is more prevalent among Directors of smaller companies.

Options could be made available in certain situations to, particularly, the Chairmen of smaller companies who may well spend two or more days per week on their responsibilities. Many companies are introduced to the main or AIM markets with Non Exec option schemes in place but as a number of these will have been in place for some years they may have been realised all or in part - therefore Non Execs holding options in quoted companies are likely to decrease. A certain number of companies are now making it clear that they would like their Non Execs to purchase a shareholding, but very few companies make this a condition. First Flight and ShareSoc certainly recommend that Non-Executive Directors hold shares in the companies of which they are Directors, of a non-trivial value. They should either have an obligation to purchase such shares or they should take part of their fees in share grants.

We suggest that a debate is needed on how much to pay Non Execs and on what basis. In return for more commitment, we suggest we do need to pay some Non Execs more in the UK, but this needs to be done in a way that reflects the need for more professionalism, time input and more scrutiny of strategy and risk.

At the end of the day companies will get what they pay for and what they deserve. If you want committed Non-Executive Directors who understand the business, think carefully about risks, long term strategy and long term success, they should be paid accordingly.

First Flight/ShareSoc recommendations:

- All Companies should have a Remuneration Committee made up of at least two Non Execs for smaller companies and three Non Execs for larger companies;
- The level of pay for Non Execs should be linked to their abilities, performance, time commitment and market conditions. Shareholders should be consulted and approve remuneration packages.
- Companies should remunerate their Non Execs in a combination of fees, shares and share options;
- Non-Executive Director fees should increase where appropriate, but in return for more professionalism, time input and more scrutiny of strategy and risk.
- Non-Executive Directors should hold shares of significant value in the companies of which they are directors.
- Share options should only be used in small, early-stage companies as an element in remuneration and under specific conditions.

Some information in this remuneration section is taken from First Flight's Survey of Non-Executive Directors with further data provided by Cliff Weight at remuneration consultants MM&K: www.mm-k.com . Cliff Weight is also the author of the Directors' Remuneration Handbook published by Bloomsbury; to order your copy on Amazon, click here

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