

INSTITUTIONAL SHAREHOLDERS' COMMITTEE

The Role and Duties of Directors - A Statement of Best Practice

1 GENERAL INTRODUCTION

- 1.1 Institutional investors are increasingly being approached by companies and their advisers with requests to indicate what in their view would be the reasonable expectation of shareholders in such matters as the provisions governing the appointment and removal of directors, the duties of non-executive directors, directors' service contracts and emoluments, their borrowing powers etc.
- 1.2 The Companies Act imposes certain fundamental obligations in respect of disclosure of emoluments, service contracts etc. Beyond this and any obligations imposed on listed companies by the Listing Agreement of The International Stock Exchange, however, there is a rich variety of practice in the composition of Boards of Directors of UK companies and in the approach to remuneration of directors, which reflects the widely different circumstances of companies across the whole spectrum of size and category.
- 1.3 The Institutional Shareholders' Committee (ISC) feels that a Statement of Best Practice such as this, which summarises the views of institutional shareholders, will enable these shareholders to give a more coherent and consistent response when their views and votes are solicited by companies. The ISC feels also that its publication will be helpful to companies and other interested bodies when considering structure and practice in these areas.
- 1.4 The Statement of Best Practice clearly cannot be exhaustive. It is hoped that companies will accept the general thrust of the Statement and that, in the absence of special circumstances, its suggested provisions will be observed in company practice.
- 1.5 The ISC supports the United Kingdom system of unitary boards. All directors have an equal responsibility in helping to provide their company with effective guidance and leadership and it is recognised that they must, and in almost all cases do, act at all times entirely in the best interests of the company. In this context the Companies Act, The International Stock Exchange book "Admission of Securities to Listing" (i.e. the Listing Agreement or "Yellow Book") and the Takeover Code all contain provisions which are relevant to the contents of this Statement, to which reference should be made where appropriate.
- 1.6 **Note on second edition**

The first edition of this document was considered in detail by the Cadbury committee and its recommendations were largely incorporated in The Financial Aspects of Corporate Governance, otherwise known as the Cadbury Report. The ISC fully supports that

Report, and where it covers the same ground as this document, this second edition includes relevant provisions of the Cadbury recommendations not in the first edition. For ease of reference, these additions have been printed in bold type.

2 THE BOARD OF DIRECTORS

- 2.1 The Board should meet regularly, retain full and effective control over the company and monitor the executive management.
- 2.2 **The Board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands.**
- 2.3 There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.

3 APPOINTMENT AND REMOVAL OF DIRECTORS

- 3.1 A director must be elected by the Company in General Meeting unless provision is made otherwise. The directors may appoint additional directors if the Articles so provide any change in the directorate must be notified to the International Stock Exchange immediately. Such an appointment terminates automatically at the next Annual General Meeting when the director would normally be eligible for election at that meeting.
- 3.2 It is suggested that, as a matter of good practice, these further provisions should be observed:-
 - (a) The Articles should provide for a maximum as well as a minimum number of directors. One-third of the directors should be subject to retirement by rotation each year. They can stand for re-election if they so choose.
 - (b) The combination of the roles of Chairman and Chief Executive constitutes a concentration of power and can give rise to conflicts. The Board has the power to appoint, monitor the performance of and, if necessary, dismiss the Chief Executive. This may be difficult if the Chief Executive is also the Chairman. The roles of Chairman and Chief Executive should not, therefore, normally be combined. In circumstances where they are combined it is unlikely that institutional shareholders will be satisfied unless there is a strong body of independent non-executive directors who are aware of their overall responsibilities to shareholders (outlined below).
 - (c) Where companies feel that they must provide for divisional or assistant directors or some other category whose title includes the word director, such persons must be clearly seen not to have any statutory authority or ability to act on behalf of the company in the capacity of a director.
 - (d) The Articles should provide that a director may only be dismissed from his or her office by written resolution of all co-directors (or at the very least a majority of 75% of co-directors) who should account to shareholders at the next general meeting for their course of action.

- (e) The Articles should provide that a director may be dismissed from office by his or her fellow directors for failure to attend a specified number of meetings of the Board "or Board Meetings held in a specific period".
- (f) Brief biographical details of each director should be set out in the Annual Report showing the directors' relevant experience and suitability. In particular, the Annual Report should disclose the ages of all directors and in the cases of those aged over 70, on the occasion when they stand for election or re-election, an explanation of why it is felt appropriate that such directors be retained.

4 **NON-EXECUTIVE DIRECTORS**

- 4.1 Institutional shareholders strongly support the presence of independent directors on Boards of companies. There has been a growing awareness of the value of audit committees and the importance of non-executive directors has become evidence, particularly in matters concerning top management succession, remuneration of the senior management and in circumstances where there is potential for conflict of interest such as management buy-outs. They 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 which he or she can contribute to the deliberations of the Board.
- 4.2 **Non-executive directors should be selected through a formal process and both this process and their appointment should be matters for the Board as a whole. They should be sent a Letter of Appointment specifying their duties, terms of office, remuneration and its review.**
- 4.3 **It is important to ensure that throughout their period of office, non-executive directors have the same rights of access to information as executive directors.**
- 4.4 A detailed Code of Recommended Practice on non-executive directors published by ProNed, which institutional shareholders fully endorse, includes the following main tasks of non-executive directors:
 - i) to contribute an independent view to the Board's deliberations;
 - ii) to help the Board provide the company with effective leadership;
 - iii) to ensure the continuing effectiveness of the executive directors and management;
 - iv) to ensure high standards of financial probity on the part of the company.
- 4.5 It is suggested that, as a matter of good practice, these further provisions should be observed:
 - (a) 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.

- (b) While all directors have a duty to monitor the performance of a company, the non-executive directors should acknowledge a particular duty to monitor the Board as a whole, 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.
- (c) Non-executive directors should be independent, i.e. free from bias, involvement or partiality. 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. Independence is more likely to be assured inter alia when the director:
 - (i) Has not been employed in any executive capacity by the company concerned within the last few years.
 - (ii) Is not retained as a professional advisers by the company (either personally or through his or her firm) and
 - (iii) Is not a significant supplier or customer of the company.
- (d) In order not to impair their impartiality, non-executive directors should not, under normal circumstances, be offered participation in share option schemes, nor in performance related or other incentivised remuneration schemes, nor in any company pension schemes. They should not be entitled to any compensation for loss of office.
- (e) Non-executive directors should hold other directorships in the same industry only with the approval of the board.

5 **SERVICE CONTRACTS**

- 5.1 As a matter of law and Stock Exchange requirements, copies of all directors' service contracts with an unexpired term of 12 months or more must be made available in an accessible place for inspection by shareholders. Service contracts may not be entered into for a period in excess of five years without the consent of the company in general meeting. The unexpired period of any service contract must be disclosed where a director is being proposed for re-election.
- 5.2 It is suggested that, as a matter of good practice, these further provisions should be observed:-
 - (a) All Service contracts should be approved by a Compensation Committee.
 - (b) Despite the legislative provisions, contracts should not run for a period of more than three years and there may be circumstances where a rolling contract should be limited to a period of no more than one year.
 - (c) Service contracts should not permit the executive directors to engage in, or have an interest in, any business similar to that carried on by any group company except with approval of the Board (though the ability to hold shares in listed companies carrying on such business is

accepted).

6 **EMOLUMENTS**

- 6.1 The disclosure required in the Annual Report of directors' emoluments and of any compensation payments in respect of loss of office made to directors is considered by institutional shareholders to be an important feature of company legislation.
- 6.2 The Companies Act and The International Stock Exchange impose certain requirements governing such payments including the issue of shares and grant of loans, guarantees etc.
- 6.3 It is suggested that, as a matter of good practice, these further provisions should be observed:-
- (a) A Compensation Committee should be appointed by the Board, consisting solely or mainly of non-executive directors (and in the latter case chaired by a non-executive director). The Committee's function is to determine the salaries and emoluments packages of the executive directors. This would include salaries and also participation in share options, profit sharing and incentive remuneration schemes and all other bonuses and benefits receivable by the executive directors. Executive directors should not play any part in deciding their own compensation packages. The composition of the Compensation Committee should be disclosed in the Annual Report.
 - (b) Those companies which do not have a sufficient body of non-executive directors to form a Compensation Committee should take steps to remedy the situation. In the interim their Annual Report should state the method by which all directors' compensation is determined.
 - (c) A summary of the details of any performance-linked remuneration schemes (**including the basis on which performance is measured**) and of all types of share option and other incentive and profit sharing and bonus schemes should be disclosed in the Annual Report.
 - (d) Details of any ex gratia payments or payments by way of compensation should be disclosed to shareholders in the Annual Report and Accounts.
 - (e) It is in general undesirable that details of any compensation payments or ex gratia payments should be subject to confidentiality agreements or similar arrangements.

7 **DUTY TO EMPLOYEES**

- 7.1 The Companies Act 1985 states inter-alia that "the matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members".

- 7.2 The ISC considers it important that this onus placed on directors by the Companies Act should not be overlooked. Directors should appreciate the significance of the role played in a company's progress by its workforce and should always consider the interests of all those involved in working together to improve their company's performance.

8 BORROWING POWERS

- 8.1 There is no requirement either under the Statutes or under the Listing Agreement that the powers of directors to borrow on behalf of a company should be limited.
- 8.2 It is suggested that, as a matter of good practice, there should be a reasonable limit under the Articles of Association on the power of the directors to borrow, which should relate to the borrowings of the group as a whole. It is desirable that the amount permitted under the Borrowing Powers Article should be stated in the Annual Report and Accounts.

9 DIRECTOR OF COMPANIES IN DIFFICULTIES

- 9.1 The Insolvency Act 1986 imposes obligations on a director once he knows that the company is unlikely to avoid insolvent liquidation.

10 MANAGEMENT BUY-OUTS

- 10.1 Considerable concern has been expressed at the inadequacy of information given to shareholders, particularly when compared with the knowledge of the business held by the management buy-out team, and also of the need to have competent independent advice. The advent of a takeover or a management buy-out imposes obligations on management to make all relevant information available and the Takeover Code imposes quite stringent obligations in bid situations. Given the potential for conflicts of interest, however, where the buy-out consortium comprises or includes management, the need for full disclosure and independent advice becomes more acute.
- 10.2 It is suggested that, as a matter of good practice, these further provisions should be observed:-
- (a) The directors must use their best endeavours to ensure that there is made available to shareholders sufficient information to enable them properly to assess the value of the company or other assets which it is proposed to sell.
 - (b) Ideally, the Board should appoint a separate committee consisting wholly or mainly of non-executive directors with direct access to independent advisers. The independent advisers should have access to all information necessary to enable them to give a fully informed opinion as to the merits of the offer. The committee should be responsible for a separate statement to shareholders, giving the views both of itself and of the independent advisers on the bid.
 - (c) The consortium should not have access to the company's usual professional advisers, since this would aggravate the conflict of interest.

10.3 The Institutional Shareholders' Committee has recently re-issued a more detailed Guidance Note to those involved in management buy-outs, to which the reader is also referred.

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