ecoDa

Report and Recommendations on Independent Directors

03 October 2023

Board composition has become an important focus in Corporate Governance, including the representation of directors who are external to the entity. With an ever-increasing focus on conflicts of interest, the focus on directors who are independent from executive management in addition to merely being external to the company has also become a growing focus area.

Independence was initially a concept applied to listed companies due to the perceived need to ensure some board members had no pre-existing ties to the entity, its management or key stakeholders, and therefore were freer to exercise their fiduciary duties to the company and its shareholders and stakeholders as a whole, free of undue influence. Listed companies were a particular focus of regulators as their dispersed ownership leads to a classic economic conundrum of how to ensure managers are accountable to weak shareholders.

Over time the concept has also migrated to unlisted companies, including family groups, where seeking more board diversity and fresh perspectives via external directors beyond their existing relationship spheres to add additional mixes of backgrounds and competencies, and to enhance management of conflicts of interest. ecoDa, in its Code for unlisted entities has also stated that *"The decision to invite external independent directors onto the board forms part of a professionalisation process. Its potential effect on boardroom behaviour and culture should not be underestimated".* The right mix of directors is today seen as a crucial aspect of board effectiveness.

In line with corporate governance practices, board members are commonly classified across the following categories:

- Executive Directors ("EDs") who are employees of the entity;
- Non-Executive Directors ("NEDs") who are external to the entity;
- Independent Non-Executive Directors ("iNEDs") who are not only external but also pass some criteria regarding independence.

In Corporate Governance, independent non-executive directors are perceived as important to satisfy the expectations of the market but also to improve the quality of proceedings.

It should be noted, however, that company laws generally do not make any distinction between different categories of board members, referring only to the board being a collective body with collective responsibility. According to most company laws, all board members have the same roles, responsibilities, and potential liabilities. It is therefore in corporate governance codes, in sectorial regulations and other sources that we see the focus on categorizing different types of directors.

Definition of independence

The EC Recommendation on the notion of independent non-executive directors

The European Commission has played an important role in corporate governance debates across the European Union. Whilst recognising the different governance systems across the European Union as a result of historical, cultural and legal environments, in 2003, the European Commission proposed a framework for Corporate Governance in order to enhance protections and disclosures. In 2005 it published its *Recommendation on "the role of non-executive or supervisory Directors of listed companies and on the committees of the (supervisory) Board*"[1] applicable to listed companies in the European Union (the "**2005 EU Independence Recommendation**") and integrated into various stock exchange codes across Europe.

The 2005 EU Independence Recommendation which applies to listed companies in the EU, defines independence as

> "**The absence of close ties with management, controlling shareholders, or the company itself**. It recognises that the determination of what independence is, should largely be an issue for the board itself to determine, based on the key parameters set out in national CG Codes".

[1] EU Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005H0162&from=IT

The EU focuses on an absence of material conflicts of interest

13.1. " ..be independent only if … free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement. "

" It is not possible to provide an exhaustive list of all threats to directors' independence; ….However, a number of situations are frequently recognised as relevant …. In this context, a number of criteria, to be used by the Board or Supervisory Board, shall be adopted at the national level. ***Such criteria, which shall be tailored to the national context, shall be based on due consideration of at least the following situations****:*

a) … not an Executive Director (or Manager) of the company or an associated company, and has not been in such a position for the previous five years;

b) is not an employee of the company or an associated company, and has not been in such a position for the previous three years;

c) does not receive, and has not received, significant additional remuneration from the company or an associated company apart from a fee received as a Non-Executive or Supervisory Director.
Such additional remuneration specifically covers any participation in a share option or any other performance-related pay scheme; it does not cover the receipt of fixed compensation amounts under a retirement plan (including deferred compensation) for prior service with the company (provided that such compensation is not contingent on continued service in any way);

d) … does not represent a strategic shareholder with a 10% or larger holding in any way;

e) does not have, and has not had within the last financial year, a significant business relationship with the company or an associated company, ….

f) .. has not been within the last three years, a partner or employee of the present or former Statutory Auditor of the company or an associated company;

g) is not an Executive Director (or Manager) in another company in which an Executive Director (or Manager) of the company is a Non-Executive or Supervisory Director, and does not have other significant links with Executive Directors (or Managers) of the company due to positions held in other companies or bodies;

h) has not served on the Board or Supervisory Board as a Non-Executive (or Supervisory) Director for more than twelve years;

i) is not a close family member of an Executive Director or Manager, or of persons in the situations referred to in points (a) to (h).

The Independent Director undertakes:

a) to maintain his independence of analysis, decision and action in all circumstances;

b) not to seek or accept any unreasonable advantages that could be considered as compromising his independence, and

c) to clearly express his opposition in the event that he finds that a decision of the Board (or Supervisory Board) may harm the company. When the Board (or Supervisory Board) has made decisions about which a Non-Executive or Supervisory Director has serious reservations, then that Non-Executive or Supervisory Director shall draw all the appropriate consequences from this. I f he were to resign, he shall explain his reasons in a letter to the Board or the Audit Committee. "

Disclosures should be made regarding the conclusions reached by the board about the independence of particular directors. Where the applicable criteria are not met, the company should disclose its reasons for nevertheless considering that director to be independent.

The Recommendation also states that companies should disclose annually in their Corporate Governance statements (as a part of annual reports), which directors they consider to be independent.

Divergent definitions and requirements across Europe

Although a handful of countries such as Poland, Belgium, Greece, and Spain have a definition of "independence" in their company laws, in most jurisdictions this is not the case. As most Company Laws do not provide any definition, the notion of independence is usually tackled in national Corporate Governance Codes as well as in codes of conduct or sectoral guidance.

Certain institutes of directors have also developed recommendations on the notion of independence that go beyond the recommendations of their country's Corporate Governance Codes and which apply to board members on all types of entity (whether listed, for profit, or not).

Independence is usually determined by a general assessment of a set of factors, like those set out by the EU and designed to ensure those categorised as "independent" are free of interfering loyalties and conflicts of interest. The notion of independence is often linked to the relationship with the company, its executives, or with a major shareholder of the company or its wider group that could potentially jeopardize a director's judgment.

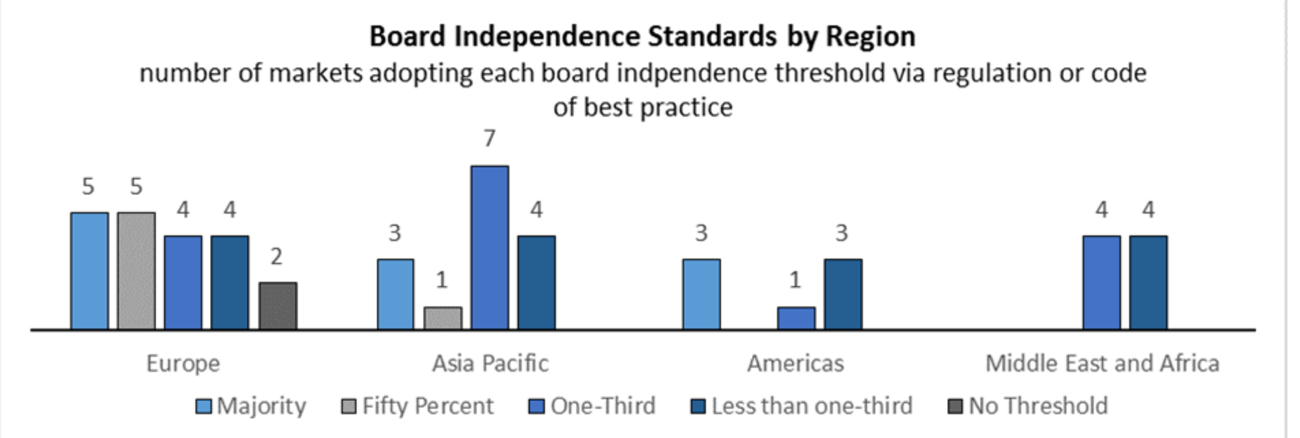
Certain Corporate Governance Codes or Company Laws give examples of situations impairing independence, such as

- having recently been an employee or an auditor of the company;
- having other business relationships with the company;
- representing a strategic or large shareholder;
- non-neutral remuneration structures
  Remuneration should also usually be limited to some form of fixed annual fee, with variable elements not to be significant in order to avoid impacting board decisions.
  For example, the CG Code in Finland specifically recommends that NEDs should not participate in the same performance-related or share-based remuneration scheme as the operative management of the company;
- long tenure (i.e. term of service)
  Most Codes set durations beyond which directors may lose the categorisation as independent - such as after having sat on the same board for a certain number of years. The period after which a director will no longer qualify as independent varies from one Member State to another but is often around 10 -12 years. After this, the director may continue on the board as a NED but cannot be considered an iNED;
- cooling off periods
  Most Codes set cooling off periods after which those who were initially considered as too close

to the entity may be considered independent - for example five years after having been an employee. Before that they can be on the board as a NED, but not qualify as an iNED.

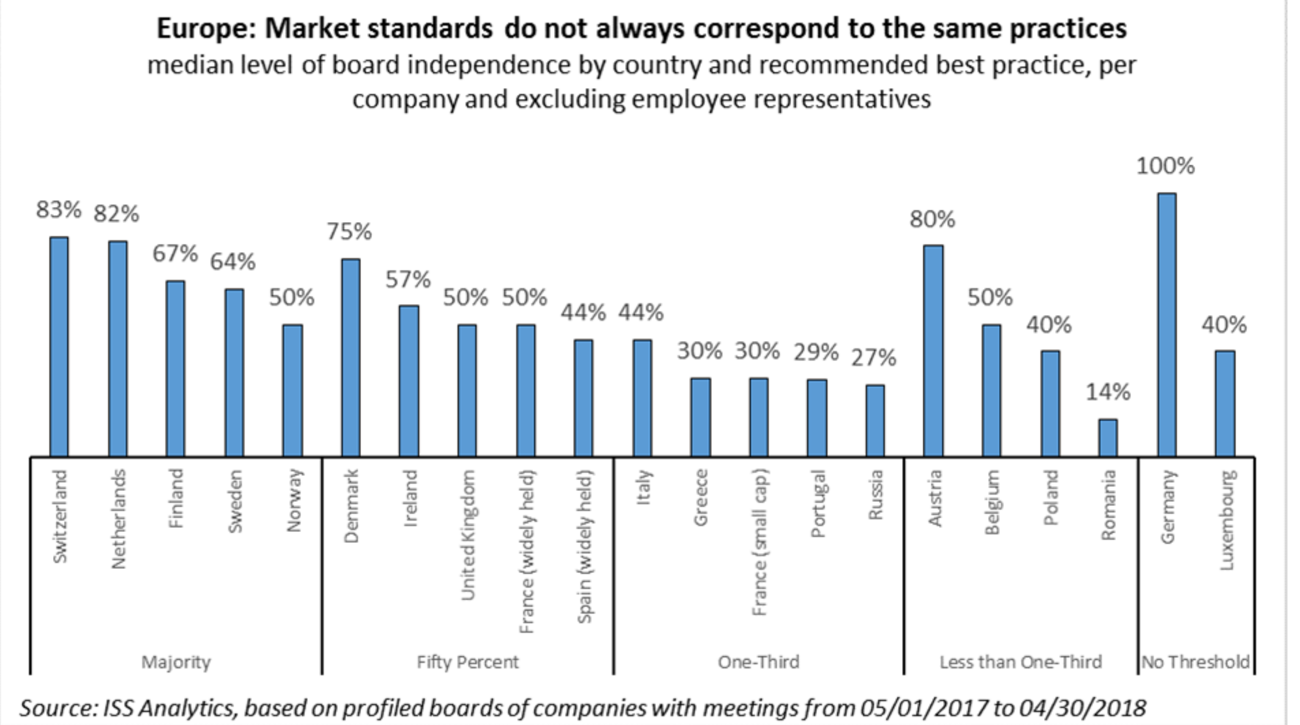
Employee-appointed directors are usually considered non-independent because of their hierarchical link to the management. Whilst some (trade unions) claim that they may be considered independent because by law they enjoy a protective status, this is mostly considered more an example of independence of mind rather than structural independence.

According to a study by ISS Research and Analytics, the independence of boards has developed over time. A differing factor in the requirements for independence lies in market maturity levels and ownership structures. The more developed a market and the more dispersed its companies in terms of the ownership structure, higher requirements for independence were found by the study.



Source: ISS Research

Best practice recommendations, which are in place in most markets, might lead to differing levels of compliance.



Source: ISS Analytics, based on profiled boards of companies with meetings from 05/01/2017 to 04/30/2018

Independence of mind

The act of exercising independent judgment is a different concept to that of "independence" of an individual, but is also worth mentioning here. It is part of the more general requirement of all board members, with the term figuring strongly in EU texts as well as those applicable to the financial sector.

"Independence of mind" is a widespread concept across the various jurisdictions, requiring all directors (whether executive or non-executive) to behave in a manner such as to participate in discussions and decisions being focused on the benefit of the company as a whole, and not on any personal interests or biases.

The Greek Company Law interestingly includes requirements for individual directors to assess their own independence of mind. A limited number of Corporate Governance Codes make recommendations along these lines.

Requirements to appoint Non-Executive Directors (NEDs)

The 2005 EU Independence Recommendation stresses the importance of having external directors on a board to add confidence in financial markets as part of ensuring robust Corporate Governance. This is relevant to the protection of investors and third parties, and the EU points to NEDs, in particular, as overseeing executives and dealing with conflicts of interest. For example, in companies with controlling shareholders, more focus is on ensuring the interests of minority shareholders and stakeholders are sufficiently taken into account.

The 2005 EU Independence Recommendation states, for example:

> "(3) Non-executive or supervisory Directors are recruited by companies for a variety of purposes. Of particular importance is their role in **overseeing executive** or managing Directors and **dealing with situations involving conflicts of interests**. It is vital to foster that role in order to restore confidence in financial markets. […]"
>
> "(7) The presence of independent representatives on the Board, capable of challenging the decisions of management, is widely considered as a means of protecting the interests of shareholders and other stakeholders. […]"

For regulated entities, such as banks or insurance companies, appointing NEDs is required and laws and regulations require that board members and officers have at all times the good repute, knowledge, skills, and experience necessary for the performance of their duties.

ecoDa's code for unlisted entities discusses the need to add external directors as entities grow and become more sophisticated, not only as a mechanism for impacting internal governance, and culture as the organisation grows and becomes more complex, but also as having significant impact on ability to raise external financing when investors review the longer-term sustainability of the entity. In two-tier structures, there is an obligation to create a supervisory board composed of only non-executives. Many CG Codes recommend a majority of non-executive directors. Behavioural economics also comes into the debates regarding balancing each board to ensure adequate influence of all board members and avoiding dominance of any one group.

Requirements to appoint Independent Non-Executive Directors (iNEDs)

Non-Executive Directors play a key role in the proper functioning of a board - being external and bringing a fresh perspective to the company. Independence is considered to bring additional value due to the absence of conflicts of interest, at least as based on various agreed criteria.

The EU focuses on sufficient numbers of iNEDs to have impact

The 2005 EU Independence Recommendation states:

"(8) In order to ensure that the management function will be submitted to an effective and sufficiently independent supervisory function, the (supervisory) Board **should comprise a sufficient number of committed non-executive or supervisory Directors**, who play no role in the management of the company or its group and **who are independent in that they are free of any material conflict of interest**"

"(18) Generally, corporate governance codes adopted in the Member States recognise the **need for a significant proportion of non-executive or supervisory Directors to be independent,** that is to say, free of any material conflict of interest."

European countries require iNEDs for listed companies and PIEs

For listed entities, most of the Corporate Governance Codes recommend having a significant proportion of iNEDs sitting on the board of directors. Some codes define this appropriate percentage to be 50% or at least one third. Where legislation is prescriptive, these often define a lower number of independent non-executive directors, even in the financial sector (two or three members).

In the Nordic system, requirements vary depending on the nature of the independence of non-executives. Not only should the majority of the non-executives be independent of the company and the management, but it is also required that at least two of them shall be independent of the company's significant shareholders.

In the majority of European countries, specific consideration is made for listed companies and also for those falling within the definition as "*public Interest entity*" or "*PIE*". A PIE status implies some rules leading to the requirement to have a certain number of iNEDs amongst the Board, such as the need to:

- Review related party transactions
  A committee of at least 3 independent directors is required to review and provide an opinion on related party transactions (Belgium, Italy);
- Have a certain number of iNEDs in certain Board committees
  Composition of specialized committees such as audit or risk committees are often required to be composed of a majority of iNEDs (Luxembourg, Sweden, Poland, France), and/or chaired by an iNED. In Greece, the approval of financial statements and management proposals to shareholders that require supermajority by a minimum of two independent directors.

It is also common to see requirements for iNEDs in boards and committees in the financial sector.

ILA's 2022 publication "*Non-Executive Directors in Luxembourg - A focus on NEDs, iNEDs and the concept of independence*" discusses in some detail the importance of NEDs and iNEDs in a board (see sections 2.2. and 2.3. in particular).

Requirements in the Nordics vary according to the nature of the independence; the obligation to be independent of the company's significant shareholders often concerns only one board member, while the need to be independent of the company and management concerns the majority of the members if not all of them.

Requirements to have NEDs or iNEDs in certain board functions and committees

The EU sees a need for external directors in key committees

Interestingly, the 2005 EU Independence Recommendation states:

> *"(9) The supervisory role of non-executive or supervisory Directors is commonly perceived as crucial in three areas,* ***where the potential for conflict of interest of management is particularly high****, especially when such matters are not a direct responsibility for shareholders:* ***nomination of Directors****,* ***remuneration of Directors****, and* ***audit****…."*

Listed and regulated companies are often subject to rules regarding the composition of the Board and Committees

Requirements vary according to the type of committees and the country. A majority of independent non-executives is often demanded. In some countries we also see that the entirety of each committee must be composed of independent non-executives.

In the same vein as the EU position, requirements are generally more restrictive for audit committees and sometimes also for committee chairs.

These requirements stem mainly from Corporate Governance codes rather than company law, with recommendations existing in most European countries, for example, board and committee chairs would usually be expected to be independent. In particular, expectations are that the majority of the Nomination/Remuneration, Audit & Risk Committees be independent. In some countries the entirety of certain committees are required to be independent (UK, Slovenia).

- In Sweden, the Code states that a majority of the members of the board are to be independent of the company and its management;
- In the UK, the chairman of the board needs to be independent on appointment, and the board has to be composed of at least half of the members, the chair excluded, to be iNEDs;
- In Italy, every year, the chairman of the Corporate Governance Committee of Borsa Italiana sends to all the chairmen of the boards of directors and board of statutory auditors, and to CEOs of the listed companies, indications on the status of implementation of the Corporate Governance Code, including the duties of the independent directors;
- In Belgium and the UK, a description of what is expected from NED / iNED (e.g. in behaviour, dedicated time…) is set out.

Independence assessments

The 2005 EU Independence Recommendation states:

> *"(18) [...] The determination of what constitutes independence should principally be an issue for the (supervisory) Board itself to determine. When the (supervisory) Board applies the independence criteria, it should focus on substance rather than form."*

In practice, it is usually the Nomination Committee that is charged with assessing the independence of each candidate when appointing a director. Boards also retain full latitude in both defining and assessing independence. The Board of Directors may consider that, although a director meets the criteria set out, he or she cannot be held to be independent owing to specific circumstances of the person or the company, such as its shareholding structure. Conversely, the board may consider that a director who does not meet these criteria is nevertheless independent. In this case, the board may need to clarify to the General Meeting the reasons why it considers that the candidate is independent.

A best practice is to include all these provisions in the company's board rulebook and Corporate Governance statement.

Independent directors are in principle also required to disclose new information that could undermine their independence. For all directors, conflict declarations are often required at the beginning of each board meeting in light of the meeting's agenda.

Assessment of the independence of non-executives is made at the time of appointment and should be renewed periodically, including following changes in a director's circumstances. Many systems require annual re-assessment of each director's independence status, and for listed entities this would be required due to the disclosures they must make in the annual reports and corporate governance statements. Specific examples include:

- In the Nordic systems the difference in the nature of independence must be made explicit and the situation is reassessed every year.
- Luxembourg and Greek legal requirements for Public Interest Entities and systemic banks also require annual re-assessments of independent non-executive directors
- In Spain, periodic reviews are also required (even if not annually).
- In other countries, like Italy or France, there are recommendations in the CG code to assess independence at least once a year, this also applies in the financial sector.

At the individual level, there are few explicit requirements requiring individual board members to (re-)assess their own independence. Some institutes of directors (such as IFA, France) have developed a set of best practices for directors to assess their own independence, whilst others incorporate this into the periodic board evaluation exercises.

Long tenure may lead to the loss of independence status

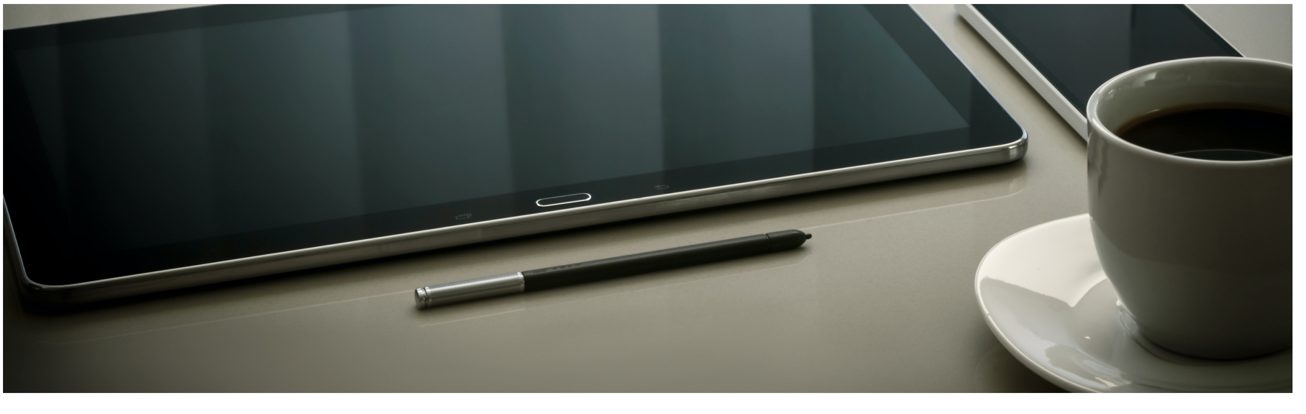
Growing and changing relationships and loyalties may lead to a director no longer being considered as independent. A director will usually not be considered independent after a certain number of years of service.

According to the EU definition applicable to listed companies, a director will be presumed to no longer be independent after 12 years on a board.

> *"has not served on the Board or Supervisory Board as a Non-Executive (or Supervisory) Director for more than twelve years;"*

Whilst term or age limits for directors or committee members may sometimes be set out in company law or an entity's articles, market practices and corporate governance principles regarding tenure and its impact on independence can be found in the different Corporate Governance codes as well as some regulations applicable to the financial sector or to PIE, for example:

- Belgium: "the technical criteria of the Corporate Governance Code include a max. tenure of 12 years, after which the director is no longer considered as independent." The Belgian Company Law also explicitly mentions that NED independence is limited to 3 terms, with a maximum of 12 years;
- Bulgaria: the National Corporate Governance Code recommends a limit of tenure. This is a general recommendation.
- Finland: "The following factors, inter alia, shall be taken into account when conducting the overall evaluation of independence: … j) the director has served as a director for more than 10 consecutive years";
- Germany and France: : the director will no longer be considered independent after being part of the board for more than 12 years ((C7 GCGK) Germany and (10.5.6 of the AFEP-MEDEF Code) France);
- Italy: listed companies: the technical criteria of the Corporate Governance Code include a max of 9 fiscal years within 12 years, after which the director is no longer considered as an independent;
- Luxembourg: in accordance with the X Principles the LuxSE, a director of a listed company in Luxembourg will no longer be considered independent after 12 years of service;
- UK: the director will no longer be considered independent after 9 years;
- Greece: according to Corporate Governance Law, the director will no longer be considered independent after 9 years;
- Poland: under The Polish Act on Statutory Auditors, Audit Firms and Public Oversight, 12 years.



Final thoughts and recommendations on an approach to independence

The role of independent non-executives is particularly important in corporate governance. It is key to ensuring proper management of conflicts of interest and that the interests of all relevant stakeholders are adequately taken into account. As a result, particular attention must be paid to the definition of this notion, to the criteria determining this status and to the evaluation over time of this qualification, and to the correct use of the term distinguishing NEDs from iNEDs. While writing this paper, a few observations were made:

- ·The EC recommendation should not be overly prescriptive. This should be left to member states in function of the national context.
- Periodic assessment of the independence of non-executives should be recommended;
- The EC Recommendation could state that national Corporate Governance Codes should also describe the specific attitudes and behaviours required from both non-executive and independent non-executive directors (incl. necessary trainings) Indeed, independence should not be limited to a set of formal factors (see for example explanatory note of the Belgian CG Committee).
- The EC recommendation could recommend having the appropriate nomination & dismissal procedures to ensure effective independence.
- More generally, we believe that CG Codes should always provide recommendations for dealing with conflicts of interests of directors.
- The Corporate Governance Codes should recommend that board evaluations more systematically take into account how conflicts of interest are managed. and include requirements regarding individual director evaluations as well as at least annual re-evaluations of independence.

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