ILA

The voice of corporate governance
in Luxembourg

NON-EXECUTIVE DIRECTORS IN LUXEMBOURG

A focus on NEDs, iNEDs and the concept of independence

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FOREWORD

Not only in times of crisis, but also in every decision a Board of Directors must take, ILA recognizes the need for good corporate governance to support companies, enable strong and sustainable growth and overcome diverse challenges. More than ever, Non-Executive Directors (NEDs), often viewed by the public and by stakeholders as guardians of their interests, have a key role to play in improving governance standards, especially regarding independence and conflicts of interest. Over the last years, corporate governance practices have evolved and matured greatly. Growing trends enhancing Board effectiveness include greater professionalization of Boards of Directors and increased diversity of the types, skills and backgrounds of Directors. With conflicts of interest as a key focus of corporate governance, appointing external Directors who are considered independent has become increasingly prominent. While Anglo-Saxon countries first placed independent Directors as a pillar of good corporate governance, today this practice has spread quickly across the globe.

The Institut Luxembourgeois des Administrateurs (ILA) has identified a need to help Luxembourg's Boards better understand how to approach the concept of Director "independence." This goes beyond any legal or regulatory requirements and must be seen in the wider context of how independence of mind relates to the concept of independence in the role of a NED. It is important to analyze stakeholder expectations, techniques for managing conflicts of interest and wider Board composition trends, "which have led to the emergence of this sub-group of Non-Executives on a Board who are considered to be "independent."

This publication aims to clarify the concept of independence and offer considerations around criteria to consider when assessing the purported "independence" of any Director.

Companies calling their NEDs independent ("iNEDs") must ensure that this is indeed the case — not just with respect to the individual assessment of a Board member, but also in the context of the collective assessment of the Board, both initially and on an ongoing basis.

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1. INTRODUCTION

The importance of corporate governance and the wider roles and responsibilities of Boards and their Directors is acknowledged by market players such as regulators, business associations, companies — and of course shareholders. To support this professionalization of Boards and the growing culture around maximizing each Board's effectiveness, professional associations such as ILA continue to expand learning and training paths for Directors.

The right mix of Directors is a crucial aspect of Board effectiveness, with Board composition focused not only on traditional competencies and skillsets but also on including wider diversity concepts such as the presence of external Directors on the Board, who are independent from executive management and external to the company (i.e., the "Non-Executive Director"). An important subset of this NED group has emerged, with Directors who are not only external, but also free from other material relationships, influences or circumstances which may be perceived as creating a potential conflict of interest (i.e., the "Independent Non-Executive Director", the iNED). References to NEDs (also in this paper) would generally include the iNED sub-set.

As more NEDs are appointed to Luxembourg Boards, "Independent Director" has become a term commonly used to refer to any external Director who is not an employee Director of a company. Some Directors consider themselves "Independent Directors" more generally, despite the fact that the concept of independence is, by its very nature, subjective and linked to specific circumstances of a particular company and mandate. Elsewhere, the dominant term for external Directors used in corporate governance circles is the broader "Non-Executive Director." In this paper we, as ILA, argue for a shift in terminology in Luxembourg to a more generic use of "Non-Executive Director", and a more considered use of the term "Independent Non-Executive Director". We believe that referring to an iNED should be restricted only to cases where the Director in question is not only external, but also fulfils various independence criteria.

The first section of this paper analyses different "categories" of "Directors" on a Board (executive versus non-executive) and the subset of NEDs who are also considered as "iNEDs"

Later sections will offer guidance and considerations for Boards to take into account when assessing a Director's independence — both initially and on an ongoing periodic basis.

The evolution of corporate governance best practices have firmly entrenched Non-Executive Directors as a key aspect of Board composition. Yet, the term independent should be used cautiously — and only following a proper review of independence criteria and the circumstances surrounding each Non-Executive Director.

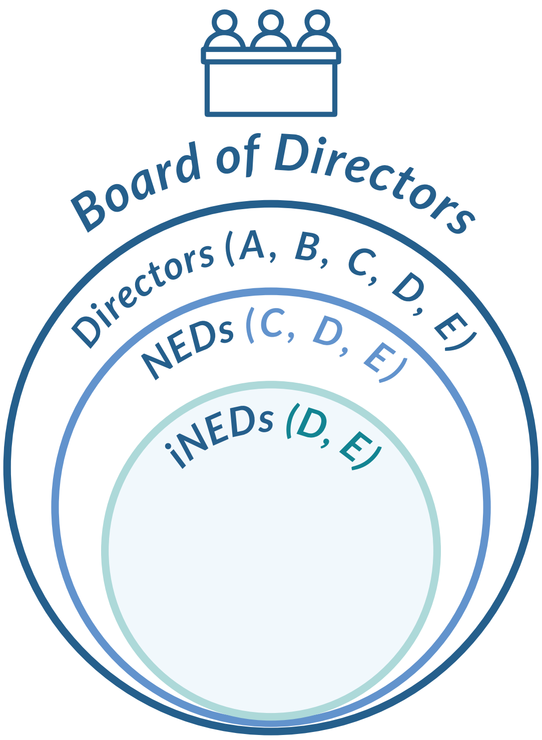
2. CATEGORIZING DIRECTORS AND THEIR ROLES

2.1 Role of a Board and of each of its Directors

The roles and responsibilities of Boards of Directors are discussed in several ILA publications, available at www.ila.lu. For the purpose of the current publication, ILA simply points out that according to Luxembourg law on commercial companies of 1915, as amended (the "Luxembourg Company Law"), a Board is the highest governance body of a company, appointed by its shareholders. The Board is responsible for setting the strategy, defining the company's vision and values and ensuring the long-term prosperity of the company. The Board is also in charge of appointment and oversight of key management. The Board is collectively responsible for these tasks and duties and is the voice toward shareholders and relevant stakeholders.

While this paper discusses different "categories" of Directors, it should be noted that this is a corporate governance concept. Luxembourg law, and in particular Luxembourg Company Law, does not make any distinction between different categories of Directors, referring only to the Board being a collective body with collective responsibility. According to the Luxembourg Company Law, all Directors have basically the same roles, responsibilities and potential liabilities.

However, in line with corporate governance practices, Directors are commonly classified across the following categories:



Directors	In a unitary Board, which is the dominant model in Luxembourg, "Director" is a term used to refer to all members of a Board of a company. In a two-tiered Board, there is a distinction between the Supervisory Board and the Executive Board. In this paper, ILA focuses on Directors who would be members of the Supervisory Board.
Executive Directors ("EDs")	Any member of the Board who is engaged in the daily management of the company. They are employees of the company or its group, including non-management employee representatives sitting on a Board.
Non-Executive Directors ("NEDs")	Any member of a company's Board who is external to that company or generally to its group. They are not involved in the day-to-day inner workings of the company and are not employees of the company or its group.
Independent Non-Executive Directors ("iNEDs")	iNEDs are a subset of NEDs who are also considered to be independent of the company or its group. The Board is responsible for setting the independence criteria and assessing and monitoring the independence of any NEDs who it will present as being independent.

These categories are also used in the European 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 (the "EU Independence Recommendation"). The EU Independence Recommendation is applicable in particular to listed companies in the European Union but has been applied more broadly across the EU. It has, for example, been integrated into the X Principles of the Luxembourg Stock Exchange (LuxSE) in its Annex D and as such applies to companies listed on the LuxSE.

Confusion between the terms NED and iNED has been frequent in the Luxembourg market. This can create misunderstanding or even result in concerns of misleading stakeholders as to the lack of connections and conflicts of interest where those they have have understood (or misunderstood) a particular interpretation of the term. "independence". Shareholders and other stakeholders — such as regulators, ratings agencies, proxy advisory firms — tend to rely on the entity's explanation of Board composition and assume certain safeguards against conflicts of interest when told that X% of a Board are "independent." ILA observes a broad global convergence in how to reasonably define independence, albeit with some nuances in thresholds where the concept has not been consistently defined by local law or regulation .

The criteria used to underpin the term "independence" are important. Yet in Luxembourg, market practice has been to use the term with little thought for the meaning behind it. Many NEDs generically refer to themselves as iNEDs to describe their general activities, even though they might have material business connections with an entity, which creates disparities in the market and confusion among investors, regulators and other stakeholders.

In order to use the distinctions of ED, NED and iNED meaningfully, a Board should first consider and adopt a written and market-acceptable definition of independence and its related criteria it should then apply these criteria prior to referring to any of their NEDs an "iNED." The language used should be selected carefully as it carries meaning and connotations. Boards should collectively and regularly reassess the independence of any Directors they have categorized as such. By analogy with practices in listed companies, Public Interest Entities ("PIE") and systemic banks where the presence of iNEDs is mandatory, this self-assessment should be complemented by initial individual declarations from each iNED and a re-assessment should be undertaken at least annually thereafter.[1]

The 2005 EU Independence Recommendation also takes this approach:

> (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.

2.2 The importance of Non-Executive Directors in a Board

A NED is defined simply as a Director who is not employed by the entity or its wider group.

Directors will usually be considered as "executive" if they exercise executive functions elsewhere in the group (despite being "external" to the individual entity Board on which they sit). This is specifically mentioned in some EU Member States, and also set out in the European Central Bank's 2021 "Guide to fit and proper assessments".

2.2.1 International perspectives

Following the 1992 UK Corporate Governance code by the Cadbury Committee, the first edition of the OECD's Principles of Corporate Governance was adopted in 1999. The OECD stressed the importance of good corporate governance to build the trust, transparency and accountability required for long-term investment and growth, and its principles have since become a benchmark for global governance frameworks. The OECD often focuses on management of conflicts of interest as a key element through disclosures, Board composition or auditor independence. Almost all stock exchanges have a code applicable to Boards of listed entities and have included some focus on the appointment of NEDs and iNEDs, as also noted in the 2005 EU Independence Recommendation. There are also various codes focused on non-listed entities, such as the Corporate Governance Guidance and Principles for Unlisted Companies in Europe" issued by ecoDa (the confederation of European Director's Institutes, of which ILA is also an active member)[2].

Since the 2000s, market data suggest that there has been a steady increase in the number of NED but also iNED appointments, slowly moving beyond listed companies and that they are becoming increasingly acknowledged as a core corporate governance tool for all companies. The financial crisis of 2007/2008 was a further catalyst to this.

1. The 2005 EU Recommendation states:

(15) In order for non-executive or supervisory Directors to play an effective role, they should have the right background and sufficient time for the job. In addition, a sufficient number of them should meet appropriate independence criteria.

Before the appointment of non-executive or supervisory Directors, adequate information should be provided on these issues and that information should be updated with sufficient frequency."

2. See 2021 edition and video of launch event at https://ecoda.eu/corporate-governance-guidance-for-unlisted-companies-in-europe/

Today, most jurisdictions strongly recommend the presence of NEDs on Boards, and it is mandatory for certain companies with the objective of promoting a balance of power in favour of broader stakeholder and shareholder interests — balanced between EDs, NEDs and iNEDs. Listed and regulated companies are often subject to more stringent rules regarding the composition of the Board of Directors and its sub-committees.

2.2.2 The EU strongly values the presence of NEDs and iNEDs on Boards

The 2005 EU Independence Recommendation stresses the importance of having external Directors on a Board in order to add confidence in financial markets by ensuring robust corporate governance principles were being applied. This is relevant to the protection of investors and third parties, and the EU points out NEDs, in particular, as overseeing executives and dealing with conflicts of interest.[3]

For listed entities, and certain regulated entities such as banks, appointing NEDs is required and also ensures that some of them should qualify as independent.

EcoDa's Code for unlisted entities acknowledges the need to add external directors as entities grow and become more sophisticated, not only as a mechanism for impacting internal governance and culture, but also as having significant impact on an entity's ability to raise external financing when investors review the longer-term sustainability of the entity.

The EU also touches on the balance between different groups on a Board when considering its overall composition and the importance of avoiding dominance of any one group in decision making. This reinforces the need to have a sufficient number of NEDs and iNEDs, who are not associated to each other.

> "3.1. The administrative, managerial and supervisory bodies should include in total an appropriate balance of executive/managing and non-executive/supervisory Directors such that no individual or small group of individuals can dominate decision-making on the part of these bodies.
>
> 4. … A sufficient number of independent non-executive or supervisory Directors should be elected to the (supervisory) Board of companies to ensure that any material conflict of interest involving Directors will be properly dealt with."

EcoDa also states

> "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".

3. 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. …."

"(6) … measures... aim fundamentally at improving the corporate governance …. since that objective is relevant to the protection of investors, actual or potential,…"

"(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. …

In companies with a dispersed ownership, the primary concern is how to make managers accountable to weak shareholders.

In companies with controlling shareholders, the focus is more on how to make sure that the company will be run in a way that sufficiently takes into account the interests of minority shareholders.

Ensuring adequate protection for third parties is relevant in both cases.

Whatever the formal Board structure of a company, the management function should therefore be subject to an effective and sufficiently independent supervisory function.

Independence should be understood as the absence of any material conflict of interest; in this context, proper attention should be paid namely to any threats which might arise from the fact that a representative on the Board has close ties with a competitor of the company…"

and specifically, also mentions the role of external directors in family institutions:

> "Family institutions can play a useful role in coordinating and unifying the interests of extended families. However, the most important step for ensuring the long-term survival of a family company is the establishment of a strong board with independent non-executive board members».[4]

How many is "sufficient"? 1/3 of external directors as a rule of thumb?

Although there is no magic number, it is commonly seen as a sign of good corporate governance to have a certain number of NEDs and iNEDs sitting on the Board. In behavioral economics research, one often sees one-third deemed the number at which the minority can have sufficient influence over the rest of the group to have an 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."

More specifically, in the financial services sector, the following is stated in paragraph 79 of the joint European Securities and Markets Authority (ESMA) and European Banking Authority (EBA) guidelines on the assessment of suitability of management Board members and key function holders (the "Guidelines"):

> "When assessing the independence of members, institutions should differentiate between the notion of 'independence of mind,' applicable to all members of an institution's management body and the principle of 'being independent,' required for certain members of a CRD-institution's management body in its supervisory function."

The Guidelines explain the concept of independence of mind by pointing out that it is a "patten of behavior, shown in particular in discussions and decision-making." It is interesting to note that assumptions should not be made:

> "The fact that a member is considered as 'being independent' does not mean that the member of the management body should automatically be deemed to be 'independent of mind' as the member might lack the required behavioral skills."

2.2.3 Corporate governance best practices focus not only on conflicts, but also on the advantages of diversity

From an international and national perspective, the presence of NEDs on a Board is an important aspect of good corporate governance.

In addition, having external Directors adds an element of diversity — not only in skills and background, but also not being part of the company or its group adds. According to widely studied research, Board diversity correlates with outperformance of a company.

NEDs are not expected to have the same operational and management knowledge about the organization as those who work there. NEDs often bring broader experience as they generally sit on the Boards of more than one company and/or may come from other sectors or geographies. NEDs enable a Board to diversify its Board composition and attract a wider set of experiences and skills and to allow for other viewpoints and objectivity to the entity's decision-making.

4. John Ward, Creating Effective Boards for Private Enterprises (1991)

Examples of commonly cited benefits include:

- Overseeing executive or managing Directors. For example:
  - Challenging, questioning and monitoring senior management (made more difficult if the Board is only composed of the management themselves);
  - Challenging and supporting the strategy proposed by senior management
  - Supporting and mentoring the CEO (in particular, by the Board Chair)
- Dealing with situations involving conflicts of interests
- Adding greater dynamism to the Board and its discussions to ensure more robust and objective decision-making processes. For example:
  - Seeing things from an external view with fresh perspectives impacts the level of debate and contributes to Board decision-making
  - Diversifying behaviors to contribute to enhanced debate and discussion
  - Avoiding internal "groupthink" and biases
- Adding and complementing Board expertise, skills and experience (beyond what may be available internally)
- For smaller companies, demonstrating maturity and formalism in reports and meetings through external Directors. The appointment of NEDs will often be required by investors, who may themselves join the Board.
- ecoDa in its Code for unlisted companies also mentions adding external directors as:

  > "a key stage in opening up the company to external scrutiny is taken by the appointment of independent (non-executive) directors. This signals a firm's willingness to become more open and accountable in respect of its decision-making and performance assessment.".

- In regulated entities, growing ability to satisfy regulators who show tendencies to look for contact with NEDs (in particular the Board Chair, and in some cases also with Committee Chairs and any Senior Independent Directors).

The 2005 EU Independence Recommendation further 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***...."

2.3 The importance of independence among the Board

An iNED is a particular type of NED.

In addition to being external to the company or its group, an iNED should also be free of business and other relationships that could interfere with — or could reasonably be perceived to interfere with — their independent judgment and behaviour.

For example, a CEO's spouse or child may join a Board and factually be external but would not be considered as independent due to their personal relationship with a member of the senior management of the entity. Similarly, a major shareholder of the entity could not be assessed as independent due to having material economic interests. These individuals could, of course, still join (or remain on) the Board as NEDs. They simply could not be considered as independent.

2.3.1 Absence of interfering loyalties and conflicts of interest

Due to their absence of interfering loyalties and conflicts of interest, the iNEDs are often perceived by investors and regulators as a key gatekeeper to ensuring the interests of the entity as a whole and that the interests of shareholders and relevant stakeholders remain appropriately prioritized and balanced by the Board. This goes hand-in-hand with the increasing demands from governing bodies to not only enhance transparency, but also provide leadership on broader themes such as sustainability and ethic. Entities are now expected to improve their corporate citizenship alongside their financial and other goals.

Over time, corporate governance theory and best practice have evolved and increased the importance of evaluating and ensuring adequate Board independence in evaluating Board composition. iNEDs are also seen by many stakeholders as a key mechanism to embedding mechanisms that allow for appropriate challenge to management without fear of reprisals and without other interests being prioritized.

Regulation has reinforced this trend in some sectors,. The Luxembourg banking sector, for example, requires Boards of significant and/or listed financial institutions to have at least one iNED. For the non-significant institutions, this is arecommendation rather than an obligation. As to the specialized committees, circular 20/759 of the CSSF states that:

> "…the permanent members of the specialized committees shall be, as the case may be, members of the supervisory body who do not perform any executive function within the institution or independent members. Each committee shall be composed of at least three members whose knowledge, skills and expertise are in line with the missions of the committee. Where there are several specialized committees within an institution and insofar as the number of non-executive and independent members of Directors to fulfill their supervisory mission and to the supervisory body allows it, the institution should ensure that the members of the respective committees are different. Moreover, the institution should try to ensure a rotation of the chairpersons and members of the committees, considering the specific experience, knowledge and skills required on an individual and collective basis."

And also:

> "The CSSF recommends that the significant institutions' risk committee have a majority of independent members, including its chairperson."

The 2005 EU Independence Recommendation states:

> (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.
>
> ***Independence*** is most often understood as the ***absence of close ties with management, controlling shareholders or the company itself***. In the absence of any common understanding of what independence precisely entails, it is appropriate to provide a general statement describing what the general objective is. Provision should also be made to cover a (non-exhaustive) number of situations, involving the relationships or circumstances usually recognized as likely to generate a material conflict of interest …. ***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.***

2.3.2 Independence of mind and Directors' duties

It is important to remember that all Board members must exercise "independence of mind," regardless of whether they are internal or external. Directors should exercise proper independence of judgement and opinion in every action or decision they make. All Directors should be able to question management and always act in the corporate interests of the company, as well as the interests of the collective shareholders and of other relevant stakeholders.

Considering the individual duties of each Director and the duties of the Board as a collective body, the Board's roles and responsibilities are defined in general terms by Luxembourg law — in particular Luxembourg Company Law and the Luxembourg Civil Code. Broadly, a Board is responsible for taking such actions as may be necessary to realize the corporate purpose of a company and to protect the interests of all the shareholders. The Board must provide strategic direction to the company. The Board may also be liable toward the company and third parties in case of breach of the laws or regulations and must ensure that an adequate governance system, including policies and controls, is implemented. As these Board duties imply, the ovesight of company management functions — the role played by NEDs — is often crucial.

In terms of efficient governance, a distinction should be made between the concept of "independence of mind" required of all Board members, and the principle of "being independent" as assessed by external criteria. To be considered as an iNED a Director must show independence of mind in addition to fulfilling various external criteria designed to assess independence and freedom from any influence or interest.

2.3.3 EU perspectives

As detailed above, the 2005 EU Independence Recommendation clearly shared the European Commission's perspective that NEDs and iNEDs are important for effective corporate governance and to protect the integrity of financial markets, especially by holding management to account and managing conflicts of interests within the Board.

> 3.1. The administrative, managerial and supervisory bodies should include in total an ***appropriate balance*** of executive/managing and non-executive/supervisory Directors ***such that no individual or small group of individuals can dominate decision-making on the part of these bodies***.
>
> 4. … A sufficient number of independent non-executive or supervisory Directors should be elected to the (supervisory) Board of companies ***to ensure that any material conflict of interest involving Directors will be properly dealt*** with.

EcoDa in its Code for unlisted companies also states:

> "All board members must take decisions objectively in the interest of the company, and also with regard to their impact on wider society. As the company develops, inviting an independent director onto the board can help in focusing the board on the corporate interest and on the wider social impact."
>
> And also emphasises that one should not underestimate the effect adding external Directors has on Boardroom culture and behaviours.

2.3.4 Luxembourg regulatory and industry specificities

Luxembourg Company Law does not provide any definition of "independence". However, this concept is extensively discussed in stock exchange listing rules, industry-specific guidance and regulations and various European Union ("EU") regulations.

At the national level, the LuxSE in its X Principles of Corporate Governance endorsed the definition of the EU Independence Recommendation by stating in its recommendation 3.5. that:

> "To be considered independent, a Director must not have any significant business relationship with the company, close family relationship with any member of the Executive Management, or any other relationship with the company, its controlling shareholders or members of the Executive Management which is liable to impair the independence of the Director's judgment."

In Appendix D of its X Principles of Corporate Governance, the LuxSE includes the criteria set out in the 2005 EU Independence Recommendation to assess the independence of Directors.

In addition to the recommendations made for listed companies, specific guidance on Director independence has also been published for regulated companies. A common factor between these regulations and guidance is a focus on ensuring the absence of material conflicts of interest. ILA believes the absence of conflicts of interest is a key (albeit not the only) element to be considered when assessing the concept of independence.

Examples include:

- Banking sector:
  - Credit institutions and investment firms are subject to the "Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body."
  - Credit institutions and investment firms must also consider the "Guide to fit and proper assessments" of the ECB dated December 2021.
  - Principle of proportionality
  - CSSF Circular 20/759
- Luxembourg Investment Funds:
  - Tend to adopt the Association of the Luxembourg Fund Industry (ALFI) Code of Conduct which recommends that the Board consider the appointment of one or more Directors that the Board considers to be independent.

  - Some regulators might have some specific rules or recommendation with regards to the presence of iNEDs.
  - Tend to have at least two NEDs.

- Insurance Firms:
  - Tend to adhere, by consistency across the whole industry, to the article 52 of the Law of 23 July 2016 concerning the audit profession (the "Audit Law") and to the requirement for majority of NEDs (or even iNEDs) in some committees such as the audit committees.

- "PIEs":
  - Subject to specific requirements in the Audit law regarding audit committees and independence for entities falling within the definition of a PIE.

- Unlisted entities:
  - ecoDa has published a Code for unlisted entities, providing a useful framework as entities scale up and grow.

3. ASSESSING INDEPENDENCE

3.1 Process to assess independence

Well before appointing any new Director, a Board should determine its policies, procedures, processes and criteria for Board evaluation and renewal, as well as Board composition requirements that may be relevant to any Director selection process. Periodically this should include a Board evaluation exercise and the mapping of the desired attributes such as skillsets, geography, behavioural traits and other criteria to ensure a diverse and balanced Board fit for governing that company and meeting its strategic objectives.

Clear process and policies

When considering the appointment of external Directors, the Board should also design a clear process to assess those external candidates, including their independence.

As mentioned earlier, subject to a few limited exceptions , there is no hard definition in Luxembourg law of "independence" for a Director, nor of the process to assess independence; the emphasis appears primarily placed on the absence of conflicts of interest.

Definitions and processes are decided by each Board, largely based on corporate governance "best practices" and the policies and procedures put in place by that Board. For those having adopted to a code of conduct, there may also be an aspect of "comply or explain in respect of the application of code recommendations," usually via the annual report to shareholders.

Clear criteria to assess independence

Before labelling a Director as independent, a Board should consider and clearly define the criteria to be applied in assessing that so-called independence. Ideally, these criteria should be included in a written document, for example a Board Charter, which is approved by the Board and kept under review on a periodic basis.

Absent such an approved set of criteria, entities should only refer to external Directors under the default umbrella of "Non-Executive Director." Despite the trend of seeing more iNEDs, the presence of NEDs who are not independent remain an important aspect of good governance. Use of the term "independent" should be restricted to only those Directors who have been individually assessed for that mandate against the relevant independence criteria. Defaulting to the term NED should avoid potentially misleading shareholders and other stakeholders.

Credibility requires consistency and transparency

To remain credible, the independence criteria should be applied consistently from one Director or assessment to another.

Best practice is for the assessment criteria to also be made available to stakeholders. Most commonly these are mentioned as part of the annual reports — (first in the Directors' report and/or corporate governance report and second in the notes to the financial statements (which should clearly set out which of the Directors are NEDs and which of these are further considered to also meet the independence test, along with a reference to where the definition or criteria of independence applied by the Board can be found). It is important that there be transparency and clarity in who is external to an entity, and out of those external Directors who pass the independence test.

Periodic review and updating of policies and procedures

Independence concepts may evolve over time, so a Board should review its definition and criteria periodically.

Periodic review of each iNEDs conflicts and continued independence

The Board should also embed a process of reassessing each Director's independence at least annually to ensure they remain within the defined criteria over time. This should include an annual self-attestation by each Director to confirm that they remain free from conflicts and restraints so as to take into account any changes in circumstances that might impair their independence status.

The assessment may change over time — even aspects such as length of Board tenure could lead to a change in assessment over time, as a sense of loyalty to management or shareholders can evolve and relationships become closer. Each iNED should annually reconfirm their assessment of independence criteria and their absence of conflicts of interest.

Where a NED no longer fulfils the Board's definition or criteria of "independence," this must be communicated immediately to the Chair and discussed with the entire Board. The Director will no longer be able to consider themselves as an iNED and would simply be recognised as a NED. In practice, this may have little or no impact on the NED remaining a Board member. However, this will ultimately depend on the Board policies, how many of the other Directors continue to be considered "independent," and whether there are any Board composition regulations or listing rules requiring a certain number of Directors be classified as independent.

Independence is highly dependent on context, and therefore subject to change both in terms of societal expectations and also as people's careers and roles evolve. It needs to be looked at not only in respect of each individual Director, but also in the context of a Board's overall composition to ensure the Board can continue to adequately manage actual or potential conflicts and Directors' interests.

3.2 All or nothing — no proportionality to independence

A Director cannot be a "little bit independent" or even kind of, sort of, sometimes or partially independent. The rule should be that it is all or nothing. Once the independence criteria are not fully met, the Director will simply remain categorized as a NED.

The concept of proportionality does not apply to the independence concept, whether it relates to external independence criteria or to the concept of independence of mind.

However, as part of the exercise of considering the different criteria for assessing independence of NEDs and in order to understand the importance of the role of NEDs and iNEDs, companies should consider their size, corporate structure and sector. Family businesses can sometimes have special considerations to keep in mind, especially if needing to balance the domination of a founder or other dominant party; proportionality could in such limited cases still play a role in assessing conflicts and deriving situations.

3.3 Transparency and disclosures

The assessment of independence of a Director should not only be performed periodically by the Board, but it should also be shared appropriately with those who rely on it, such as the shareholders.

EcoDa's Code for unlisted companies recommends, for example, that this be done in the annual report, and that not only the names of the non-executive board members whom the board determines to be independent should be disclosed but also the reasons for that assessment where necessary.

As with all governance concepts, independence should never become a "tick-the-box" exercise. A "case-by-case" analysis is required based on the specific situation, information, and pre-agreed criteria.

Both the criteria used to assess independence and also the rules that determine which Directors align within those criteria and are considered by the entity as independent should be transparent and made available to the stakeholders. Shareholders, regulators and other stakeholders might have their own definition or criteria for determining independence that they apply when assessing whether they are satisfied with the Board's own assessment of independence. In order to ensure no one is being misled by an entity holding out one or more of its Directors as being "independent" and "Independent Non-Executive Directors," it is important that these stakeholders can themselves review the definition and criteria which are applied.

To assist Boards in their definitions and assessment criteria of independence, this paper presents a list of what ILA would consider as red lines which should never be crossed and should disqualify NED from being considered as "independent," as well as further areas where the entity may have more discretion when setting its definition and criteria for independence among its NEDs.

4. THE KEYS TO ASSESSING INDEPENDENCE: ASSESSING CONFLICTS OF INTEREST

4.1 Absence of material conflicts of interest

The starting point to assess the independence of a Director is to consider whether there is an absence of material conflicts of interest.

To be independent, a Director must be free from legal or personal constraints and able to make objective decisions, even when this leads to a different view from that of management, key shareholders, stakeholders or others within the entity's sphere of functioning.

It is important to note the emphasis on the absence of conflicts of interest that is made by the European Commission in its 2005 EU Independence Recommendation. ILA considers the EU position as the basis for elaborating a definition or criteria for the assessment of independence by Luxembourg entities, especially its Annex which sets out various relationships or circumstances usually recognized as likely to generate material conflicts of interest. Various considerations can be found in Annex D to the X Principles of the LuxSE and in Annex 1 of the CSSF Circular 20/759.

> 13.1. A Director should be considered to be independent only if he is 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. [5]

This requires that Boards first consider the topic of conflicts of interest. Boards will usually have adopted some form of conflicts policy, whether as a standalone policy or as part of its governance charter.

In accordance with Luxembourg Company Law and an entity's articles, conflict declarations are made by each Director at the beginning of each Board meeting in light of that meeting's agenda. In addition, best practice is that no Director should participate in discussions or decisions on matters where they have a conflict or could be perceived as having one due to outside influence or interest. This is usually set out in the entity's articles and governance charter. For pecuniary interests defined as "opposed to the interests of the company," this is also required by the Luxembourg Company Law. In such cases, the Director should declare their interest at the beginning of the relevant Board meeting at the latest and recuse themselves

5. 13. Independence

13.1. A Director should be considered to be independent only if he is 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.

13.2. A number of criteria for assessment of the independence of Directors should be adopted at national level, taking into account the guidance set out in Annex II, which identifies a number of situations reflecting the relationships or circumstances usually recognised as likely to generate material conflict of interest. The determination of what constitutes independence is fundamentally an issue for the (supervisory) Board itself to determine. The (supervisory) Board may consider that, although a particular Director meets all the criteria laid down at national level for assessment of the independence of Directors, he cannot be considered independent owing to the specific circumstances of the person or the company, and the converse also applies.

13.3. Proper information should be disclosed on the conclusions reached by the (supervisory) Board in its determination of whether a particular Director should be regarded as independent.

13.3.1. When the appointment of a non-executive or supervisory Director is proposed, the company should disclose whether it considers him to be independent; if one or more of the criteria laid down at national level for assessment of independence of Directors is not met, the company should disclose its reasons for nevertheless considering that Director to be independent. Companies should also disclose annually which Directors they consider to be independent.

13.3.2. If one or more of the criteria laid down at national level for assessment of independence of Directors has not been met throughout the year, the company should disclose its reasons for considering that Director to be independent. To ensure the accuracy of the information provided on the independence of Directors, the company should require the independent Directors to have their independence periodically reconfirmed.

from the discussion and from voting on that agenda item. Minutes of the meeting should reflect carefully the director's declarations.

In some entities, particularly listed companies and within the financial sector, ILA also sees registers of conflicts maintained on an ongoing basis by Boards which reflect lists of relationships or situations which could give rise to a conflict of interest.

As defined in Annex II to the 2005 EU Independence Recommendation (as also set out in Appendix D of the LuxSE's X Principles), conflicts of interest may arise from many different situations and relationships, as a result of :

- **Economic interests:**
  - shareholdings or other material ownership rights
  - memberships, holdings and other economic interests in commercial customers
  - intellectual property rights
  - loans
- **Relationships — whether personal or professional:**
  - with qualifying owners of the entity or associated entities
  - with staff of the entity or associated entities (e.g., close family relationships)
  - with relevant external stakeholders (e.g., if associated with material suppliers, consultants or other service providers)
- **Employment or recent previous employment**
- **Competitors —** membership in a body or ownership of a body or entity with conflicting interests
- **Political influence or political relationships**

Each Director should provide adequate information regarding any actual or potential conflict of interest.

4.2 No significant business relationships with the entity or its group

The EU Independence Recommendation (and also Appendix D to the LuxSE X Principles), states that a current or recent significant business relationship with the company or its affiliated entities raises conflicts concerns and is, therefore a barrier to being considered independent until a certain period has elapsed:

> "…does not have, and has not had within the last financial year, a significant business relationship with the company or an associated company, either directly or as a partner, shareholder, Director or senior employee of a body that has such a relationship. Business relationships include the situation of a significant supplier of goods or services (including financial, legal, advisory or consulting services), of a significant customer of the company, and of organisations that receive significant contributions from the company or its group…"

Any type of business relationship a NED (or by their company, associates or related parties) may have with the entity, any of its key personnel, key shareholdersor its group for services or goods could be considered as creating potential conflicts provided it is sufficiently significant. This could include significant, key or long-term relationships with consultants, layers and key suppliers in the financial sector such as domiciliation administration and depositary services providers to the entity or group.

A Director should not have divided loyalties

The starting assumption will usually be that a NED or their related parties who are suppliers to the entity or its group trigger conflicts and thus prevent such a NED to also be considered as "independent."

It is important for Directors to remain free of any relationship that could interfere with the proper exercise of their independent judgement. When the Director is involved in providing services or goods to the entity, directly or indirectly, the starting assumption is that a conflict of interest exists and leads to necessary assessment of the particular circumstances and possible consequences. The same applies when an entity is connected to or associated with the Director (e.g. when the Director is also a shareholder, partner, employee or other type of relationship through their own company, an associated company or a company associated with them him/her through close family members).

Avoiding conflicts of interest — both real and perceived

The Board is required to consider substance over form when assessing what is a "significant" or "material" business relationship and a potential conflict of interest.

Pre-agreed Board policies should specify that a certain de-minimis financial consideration may be acceptable; the relevant amount should be considered as not impacting the independence definition and criteria by the fact that the amount is immaterial.

Should such a situation occur, the Board collectively should assess the nature of the service or sale of goods and any impact on the independence status or the need for any related, detailed disclosures. The Board may also need to implement measures to prevent and mitigate risks of conflict of interests. The Board should bear in mind that not only actual, but also perceived conflicts should be managed — anything that might cause stakeholders to question the independence status.

As part of the entity's policies, Directors should routinely declare all significant business relationships so that the Board is able to fully assess the extent and nature of that relationship and to determine conflicts of interest concerns.

As part of the entity's policy's Directors should routinely declare all significant business relationships in order that the Board be able to assess the extent and nature of that relationship and determine conflicts of interest concerns.

One financial year cooling off period for business relationships

Regarding the impact on the independence status of a NED, the EU Independence Recommendation sets out as a minimum cooling-off period for all significant business relationships of one financial year during which a NED may not be considered as having sufficient independence, which appears to be a little longer than one year as it looks back to the "last financial year".

The Director must not receive significant remuneration

The 2005 EU Independence Recommendation also specifically excludes the possibility that the Director is or has been receiving other significant remuneration beyond their Director's fees:

> ***"…not to receive, or have received, significant additional remuneration from the company or an associated company*** apart from a fee received as non-executive or supervisory Director. … "

Relevant facts may include the Director's possible role at or link to the service provider acting or having acted for the entity, the length of that relationship, and any ongoing connections such as stock, family or other connectors, leading to longer cooling-off periods being more appropriate. In most cases, the Director in question may still be appointed as a NED but would not be able to qualify as an iNED. Yet, it would be up to the Board to assess the extent of the conflicts and measures required to manage them .

No independence by default

Lawyers often hold that they are independent per se simply by virtue of the rules organizing their profession. When this view is applied to lawyers sitting on company Boards while concurrently carrying out professional services for the relevant entity either themselves or via their firm could confuse the different aspects of Director independence and disregard the primary purpose to identify and manage possible conflicts of interest.

Just as any professional services firm may need to refuse a client mandate and to implement ethical walls to minimize the result of conflicts of interest, the question here is also one of proper identification and management of actual or potential conflicts of interest.

If the lawyer or consultant or their firm or associates act as regular advisers and consultants to the entity or its group, it is difficult to see why that should be treated any differently to the business relationships analyzed above as all human issues of bias and conflicts would apply equally regardless of profession. The Director would not be considered as independent in the sense of corporate governance theory and best practice. This would also extend, for instance, to situations where the Director's spouse or child acts as the entity adviser (see personal relationships below), although this or other examples would require a careful case-by-case analysis.

At the other end of the spectrum, occasional legal or consultancy services of non-material value and without an ongoing relationship with the professional services firm may not be sufficiently significant to raise conflicts of interest issues.

These elements and examples should be considered by Boards to consider when developing their independence policy and criteria the main aim of which should be to avoid actual, potential and perceived conflicts of interest. Board policies should consider substance over form when assessing what is a “significant” or “material” business relationship.

Participation in Boards from the same group

How should a Director who sits or sat on Boards of other entities approach Board membership for another part of the same group?

This is particularly relevant for the discussion about length of service and at what point in time would it be reasonable to presume that the Director should no longer be considered as independent”. Do not overlook the added value of an appropriate mix of both new Directors and longer-serving Directors may hold valuable information and input on the history of the entity. This is discussed in more detail in the section on Board Composition and Tenure.

Cross participation in Boards from competitors

Any formal or informal agreement to swap Directors carries a risk of potential impairment of a Director’s independence status.

Links with a competitor

Although not directly related to cross participation, the EU Independence Recommendation refers to sitting on the Board when having strong links to a competitor:

> “…not to be executive or managing Director in another company in which an executive or managing Director of the company is non-executive or supervisory Director, and not to have other significant links with executive Directors of the company through involvement in other companies or bodies; “

Other criteria to be assessed based on individual facts and circumstances:

Each Board should complement the above-mentioned criteria with other relevant business considerations or relationships specific to the company or to any Director.

Boards should in that spirit determine whether the rule should be that any NED who falls under at least one of these criteria should not be considered as independent and should not be held out as an iNED.

Subject to any considerations relevant to the overall Board composition, Directors no longer qualifying as an iNED would of course be able to continue their mandate as a NED.

4.3 Ex-employees

People who have worked for an entity, or its group, will usually build some form of co-identity and loyalty to that entity and group. They will also build relationships across the group with others working there and may even have special attachments to particular projects or groups. As a result, it is considered that this kind of history could taint the views of ex-employees acting as Directors, albeit the strength of relevant ties and loyalty are seen to gradually fade over time as ex-employees would build new relationships and would grow their identity outside of that entity and its group.

4.3.1 Having been an executive or managing Director of the entity or an associated entity

The EU Independence Recommendation refers to a minimum cooling-off period of five years for anyone who has been part of the management or held executive functions within the entity or its affiliates.

> "is 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;"

On the back of this, the X Principles of the LuxSE also recommend a five-year cooling-off period for Directors sitting on the Boards of listed companies in Luxembourg.

In the absence of a specific period in the Luxembourg law, each Board should consider a minimum cooling-off period as part of their definition of independence.

When assessing cooling-off period for ex-management, Boards of unlisted entities might refer to the EU Recommendation and the X Principles of the LuxSE which apply to listed companies. In addition, ILA suggests that any Boards of unlisted entities could consider shortening the cooling-off period for ex-management, if surrounding circumstances indicate this could be appropriate (e.g. six months versus six+ years of employment). Boards of unlisted entities should complete an in-depth analysis of the particular type of entity, its business and the manner in which it operates in the light of the ex-executive candidate Director's personal status, time of employment and involvement in the management decision-making process when considering the appropriateness of any shorter (or longer) cooling-off period.

4.3.2 Having been an employee of the company or an associated company

The EU Independence Recommendation contains a minimum cooling-off period of three years for anyone who has been an employee of the company or of any of its affiliates:

> "...is not an employee of the company or an associated company, and has not been in such a position for the previous three years..."

As a result, in accordance with the X Principles the LuxSE, a three-year cooling-off period is required for listed companies in Luxembourg.

Boards of unlisted Luxembourg entities may consider the type of entity and how long the person had worked there (e.g., six months versus six+ years of employment) when considering the appropriateness of a shorter cooling-off period as part of their definition of independence. In the meantime, the person may join the Board and be considered as Non-Executive, just not independent.

4.4 Board composition and tenure: Should I stay, or should I go?

The EU Independence Recommendation says that after having served on a Board as a Non-Executive (or supervisory Board Director) of a company listed on a regulated market for a long period, it is presumed that the Director will have built sufficient relationships and loyalties that might impair the Director's impartiality and independence:

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

As a result, in accordance with the X Principles the LuxSE, a Director on a listed company in Luxembourg will no longer be considered independent after 12 years of service.

Subject to wider Board composition considerations (such as Board skillset, diversity, culture, etc.), this Director may continue to serve on the Board as a NED, just not be considered as an iNED.

No tenure limit is currently defined in the Luxembourg law, and ILA considers that each Board should set a maximum tenure limit above which the independence status should be questioned in the light of the EU Independence Recommendation and LuxSE's X Principles mentioned above.

4.4.1 Board composition

Composition of a Board varies from one entity to another and is also influenced by the entity's size, its sector, if the entity is listed or regulated, etc.

Some entities, such as listed companies, credit institutions and investment firms, must appoint a sufficient number of iNEDs in accordance with EU or Luxembourg regulations. Credit institutions, insurance and reinsurance undertakings, PIEs and any company whose transferable securities are admitted to trading on a regulated market are also required to have an audit committee with a majority of independent members[6].

Balanced Board composition lies with the Board itself

Appointing a balanced mixture of EDs and NEDs is an important part of ensuring a balanced Board as each brings its own value and perspective to a Board's effectiveness. A key aspect of Board composition is Board diversity. Having diverse experience, backgrounds, and types of Directors is seen as part of ensuring an environment for higher quality Board debate and decision making.

The EU Independence Recommendation stresses the importance of the Board's role in determining the best balance of persons for their own Board. It is the collective responsibility of each Board to define the targeted proportion of NEDs and iNEDs to create the right balance to achieve meaningful results for the specific entity, its sector and its shareholding structure. Often a threshold of one-third of the Board being iNEDs is considered as a minimum threshold. According to the results of studies in behavioural economics, is held that this is the minimum threshold for any subgroup of persons to come into a position of being capable of having an impact on the behaviour of the group.

Board committees

The Board should also ensure that the composition of Board committees is appropriate, including the presence of an adequate number of NEDs and iNEDs, where appropriate – especially where rules require a majority of iNEDs to sit (or chair) committees such as the Nomination and Remuneration Committees, Risk Committee and the Audit Committees.

6. Article 52 of the law of 23 July 2016 as amended

4.4.2 Board tenure – looking at length of service

Board tenure (i.e., how long a Director has served on that Board) can also be viewed in light of Board diversity and wider composition considerations. To function optimally, a Board should be composed of a mixture of long-tenured members along with newer members viewing the business with fresh eyes and perhaps fresh skillsets.

At what point should longer serving Directors be considered as NEDs and no longer as iNEDs?

A frequent question is how long a NED can sit on a Board and continue to not only behave, but also be considered as independent. The issue here is not that a Director ought to, some stage to leave the Board[7], as that is part of the wider Board composition discussion and considerations around ensuring a mix of longer standing and newer Board members. However, at a certain point, relationships will have become stronger, and friendships may have been formed. Those same type of loyalties discussed in relation to ex-employees could develop in the external Director who has come to know the entity, its group and its key actors so well over a period of many years.

As previously mentioned, "independence" should be reassessed on a regular basis and even self-assessed by the Directors themselves. Growing and changing relationships and loyalties may lead to a Director no longer being considered as independent:

- Relationships with management can grow closer over the years — especially for the Board chair due to their closer collaboration and frequent dealings with the company executives — and can call into question the independence status of a particular person.
- Stakeholders' perceptions should not be ignored and societal expectations in terms of independence may impact how this is perceived.
- Risk may be higher when living in the same country and socializing in similar circles as the group's key executives.

As part of their governance policies, Boards should consider terms of service and also reappointment for each category of Directors and for each Committee.

The cut-off on listed entities

According to the EU definition applicable to listed companies, a Director will be presumed 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..."

As a result, in accordance with LuxSE's X Principles, after 12 years serving on the Board of a company listed on the primary market of the LuxSE, a Director will no longer be considered an iNED based on the foregoing definition of independence.

However, listed companies are few, which leaves the question of how long is too long in other situations.

7. Irrespective of any Board Regulations or Articles rules providing for age limits of Board members

There is no clear rule, and it can be looked at in different ways.

Boards should set their criteria in writing, an important aspect of overall Board composition and orderly organization of Board renewal, including ensuring the desired mix of internal, external and external independent Directors across that Board.

Investment Funds — when does the clock start, and when does it end?

Many Directors in Luxembourg serve on the Boards of investment funds, and sit on several such Boards (whether currently or previously) for the same Initiator or Promoter group.

Luxembourg-based Fund Directors are highly specialized and located remote form the Promoter

Fund NEDs will often be chosen for a combination of their expertise and their being Luxembourg-based. With the Promoter group elsewhere, they play an important role in linking to local market practice and institutions and ensuring compliance with Luxembourg laws, regulations and corporate governance practices.

Fund NEDs will not usually socialize in the same circles as executives of the Fund group; the NEDs and iNEDs are predominantly based in Luxembourg while the Fund group's key executives are scattered across other locations with larger trading traditions, such as UK, USA, Switzerland and various European capital cities. Obviously, for Luxembourg-based groups this will be different.

These Fund NEDs are also often highly specialized due to the intricacy of the relevant regulations. Additionally, the EDs involved tend to change frequently, and Luxembourg-based NEDs are often tasked with ensuring the continuation of the corporate history and other valuable information for the entity to avoid loss of institutional knowledge and to avoid inefficiency should the newer Board repeat actions already taken in the past. In addition, the complexity of Fund and sub-fund structures, products, strategies and providers may also mean it takes longer for new NEDs to be fully up-to-speed, so balancing longer tenured NEDs with shorter tenured NEDs becomes very important.

Length of service of family of Funds brings up question: What is the beginning?

As each Fund is usually an orphan in order to segregate assets for only the benefit of the investors into that particular Fund vehicle and strategy, these Funds are not legally related to each other. When filling out one's list of mandates for the CSSF, one can note, however, that they are currently considered as one single "relationship."

As Fund Directors will claim multiple Fund mandates as a single relationship for regulatory purposes, it seems logical that these also be looked at as a group at relationship level for the purpose of length of service. The same approach of viewing them as one group should be applied for non-regulated funds.

Important to ensure appropriate Board composition, including periodic refreshment of NEDs

Some Funds will be created for a particular time period, and it may not make sense to change the Board during that Fund's lifecycle. This is complicated if, as discussed above, a NED sits on multiple Funds for the same Initiator or Promoter. As conflicts of interest and protection of investors and other third parties are primordial in Fund governance, robust challenge and debate are crucial. The Board should ensure that the principal of substance over form as stressed by the European Commission is prioritized when evaluating the appropriate caps on overall service on a Board of Directors. Examples include specifying term limits, renewal limits and time limits in their chosen definition of independence.

4.5 Personal Relationships

The EU Independence Recommendation and Appendix D of the X principles of the LuxSE state that a close family member of anyone caught by any of the other categories will not be able to claim independence due to their close relationship with someone that creates an actual or perceived conflict of interest:

> "…is not a close family member of an Executive Director or Manager, or of persons in the situations referred to in [see Annex D to the LSE X Principles]."

Personal relationships should be taken into consideration while assessing the independence of a Director. A Director cannot be considered independent if they have a close relationship or is a close family member of any person or entity that itself raises conflicts concerns (such as close relationship with a senior employee, qualifying shareholder or significant service provider to the company or its affiliated entities).

Disclosures should be made regarding any Director having such personal relationships, irrespective of the discussion on independence.

4.6 Significant Shareholdings

The EU Independence Recommendation sets out that representing a strategic, major or a controlling shareholder — defined as a holding of 10% or more in the company — will lead to an assumption that impartiality is compromised:

> "…is not and does not represent a strategic shareholder with a 10% or larger holding in any way…"

As a result, in accordance with the X Principles the LuxSE, a Director on a listed Luxembourg company holding alone or with related parties has 10% or more of the shares in issue will, therefore, not be considered independent.

Where a NED has a significant economic interest in the entity, their independence is impaired or might be perceived as such by the stakeholders and general public.

A relationship can interfere with the exercise of a Director's independent judgment. The fact of being a shareholder and/or representing a shareholder could per se be considered as triggering the loss of "independence" status.

While the EU Independence Recommendation applies to listed entities, it may be worth considering the shareholding structure of an unlisted entity when assessing a shareholder's influence and loyalties. ILA believes that whether listed or unlisted, similar considerations apply and recommends that all companies consider applying at least this same 10% materiality threshold in line with the EU Independence Recommendation..

4.6.1 Representing a shareholder creates conflicts

All Directors are collectively responsible toward all shareholders, and it is their responsibility to protect the interests of all shareholders, and not only of a shareholder who happens to have nominated them. A distinction though should be made between "representing" one or more shareholders and merely being nominated by a shareholder but not being beholden or responsible to that shareholder in any way — which will usually not impair the independence of that Director.

This distinction may impact the independence of a Director regardless of their level of shareholding if the Director is supposed to act according the shareholder's instructions and wishes, as opposed to applying their own independence of mind during Board discussions and debate.

4.6.2 Luxembourg state and its appointees to Boards

A special Luxembourg law 26 July 1990 sets out various particularities regarding the status, duties and liabilities regarding persons nominated by the Luxembourg State to represent it in the Board of a public limited company ("société anonyme") in which the State is a shareholder. These peculiarities clearly impact the independence of a Director appointed by the Luxembourg State regardless of the level of shareholding in question.

These Directors are required to act according to the shareholder's instructions and wishes as opposed to fully applying their own independence of mind during Board discussions, debate and decisions. They are fully immunized by the Luxembourg State from being responsible and/or liable should any issue arise.

These Directors are NEDs but will not be considered independent.

4.7 Partners or employees of the present or former statutory auditor of the company or an associated company

A cooling-off period of three years is recommended in the EU Independence Recommendation for auditors to the entity or its affiliates.

> "…is not, and 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…"

As a result, in accordance with the X Principles the LuxSE, a three-year cooling off period is required to be applied by listed companies in Luxembourg.

Again for non-listed entities, Boards should assess their own criteria. For example, if the services were de minimis and peripheral, such as a small, one-time piece of advice by an audit firm as opposed to regularly acting as the entity's auditor.

4.8 Director remuneration and its potential for conflicts of interest

Directors, and in particular NEDs, receive remuneration in compensation for their role and responsibility as Director of an entity.

EDs are most often compensated via their usual employment salaries for their executive functions without additional compensation for being on the Board.

NEDs, except those employed by the group, are not employees and do not have the same regime. Therefore, external Directors typically receive a fixed fee as remuneration for their Board mandate.

A fixed annual amount is the most common as it is seen as best to avoid actual or perceived conflicts of interest or distorted motivations for strategies or decisions. Additional fixed amounts may be awarded for any committee and/or chair roles; in some limited circumstances, a variable fee could be paid. A remuneration policy, which sets the remuneration principles for Directors should be drafted and approved by the Boards.

Beyond these general considerations, ILA sets out below some considerations around other forms or remuneration and how these may impact proper assessment of Directors' independence.

Boards should always bear in mind that not only actual, but also perceived conflicts, should be considered and managed. Stakeholders could question apparent impairment in the independence status due to compensation practices.

4.8.1 Variable Director remuneration

While variable remuneration of Directors is less common, it may be warranted in some circumstances.

One-time payments are generally considered more appropriate, while links between Board remuneration and ongoing performance of the company should be avoided as these are generally considered to trigger conflict concerns. The life cycle of a company may also be relevant, as ILA sees more variable remuneration in the early stages of a company.

In all cases, the structure and nature of the variable remuneration, as well as safeguards must be documented and approved in advance. The balance between fixed and variable remuneration should also be considered.

For example, variable remuneration may sometimes be used in the following circumstances:

- Ad hoc missions
  - To reflect a Director's or Board's involvement in an ad-hoc mission(s) on behalf of the Board for a specific operation. This must however remain closely linked to the Director's Board role (such as governance aspects of M&A or post-merger integrations) and not stray into wider consulting or similar services.

- In the start-up phase of an entity
  - In early-stage start-ups, it is more common to see some variable remuneration forhigher-than-expected commitment as it is harder to predict the growth and therefore required commitment.
- IPOs
  - The same may apply with respect to IPOs, major M&A or other major structural changes which are seen as temporary and therefore not meriting a permanent change in Board remuneration, yet still warranting temporary additional reward of Directors.

In many ways, the above examples are akin to bonuses for Board members, and if paid, should be appropriately considered, documented and justified. As the shareholders are generally tasked with approving Board remuneration, such amounts may also need approval from them.

The EU Recommendation and Annex D of the X Principles the LuxSE provides:

> "...does ***not receive, and has not received, significant additional remuneration from the company*** or an associated company apart from a fee received as 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 amounts of compensation under a retirement plan (including deferred compensation) for prior service with the company (provided that such compensation is not contingent in any way on continued service)... "

Boards may agree in advance as part of their policies that a certain de-minimis fee amount may be acceptable and not considered to impact independence due to the immaterial amount. Specifics should be included in a Board's independence definition. Should such a situation occur, the Board collectively should assess the nature of the service and any impact on the independence status, as well as the need for any related disclosures and their detail.

4.8.2 (Over-)dependency to this Board's or group's remuneration

It is important that a Director considered as independent remains able to step down from a Board if necessary, for example, in the event of a material disagreement with a course of action.

Although inherently very subjective due to differing lifestyles and family structures, as part of a Director's own self-assessment, it is recommended the Director considers how dependent they are on this particular Director's fee for overall living needs. The Director should consider this across the "Relationship" or "Group" llevel if holding several mandates for the same group. As will most often be the case for Directors on investment funds, mandates across the fund "family" should be considered together as a single relationship, in a manner similar to how the Director may group these on their CSSF mandate list.

ILA considers that this is a matter for personal reflection by each Director regarding wider personal circumstances and is not a matter for intrusive wider discussion or disclosure.

4.8.3 Equity-based remuneration

There are different schools of thought around Directors holding, and/or being paid, in equity. Some authors consider that Directors and management should hold shares in the entity to ensure they have 'skin in the game' and alignment with the entity's shareholders. However, others believe the opposite that being remunerated by short-term share price movements may pervert longer-term thinking and the decision-making process.

Start-ups, in particular, may use more creative remuneration methods due to being cash-strapped in their early days, and it is not uncommon for the Directors in an entity preparing to IPO to also benefit as part of the IPO arrangements.

In general, it is considered acceptable for NEDs to hold shares in a company and still be considered independent provided they do not hold above a certain percentage and do not hold options with performance rights which are considered as compromising objectivity.

Of note in this respect is the EU Recommendation and Annex D of the X Principles the LuxSE provide:

> "…does not receive, and has not received, significant additional remuneration from the company or an associated company... Such additional remuneration specifically covers any participation in a share option or any other performance-related pay scheme…"

CONCLUSION

NEDs play a key role in the proper functioning of a Board. Being external to the company and uninvolved in day-to-day management of the company's affairs, NEDs bring a fresh perspective to solving and addressing strategic issues facing the company.

A NED who qualifies as an iNED brings additional value with their ability to challenge executive management even more due to a lack of conflicts of interest and they have wide ranging experience. An iNED may feel free to walk away from a mandate based on convictions and regardless of financial advantages.

In an evolving and complex corporate world, both governance best practices and regulation are advocating NEDs and especially (more) iNEDs on Boards. While regulation and legislation have set some principles or rules, the definition of an iNED varies from jurisdiction to jurisdiction and from sector to sector.

The Board of Directors thus has a key role to play in defining the independence criteria that should apply to its members on a continuous basis. This is more necessary for non-listed and non-regulated companies where there are few or no guidelines. Many factors need to be considered: the size, composition (diversity), percentage of iNEDs, the Chairman's profile, fees, tenure, etc.

Given the diverse scope of the companies that exist, a "one-size-fits-all" approach should not be adopted. The Board should set a framework that is appropriate for their company and should review this on a regular basis.

iNEDs are required to ensure independence criteria continue to be met by them. At least once a year, they should formally confirm compliance with such criteria in order to maintain their independence status.

LIBRARY

- ALFI Code of Conduct for Luxembourg Investment Fund - Guideline on Director Independence dated October 2017
  https://www.alfi.lu/getattachment/1f4ee465-6db1-4e8c-82ab-7916adafcbc8/app_data-import-alfi-alfi-code-of-conduct-guidance-director-independence.pdf

- Corporate Governance - The X Principles of Corporate Governance of the Luxembourg Stock Exchange dated December 2017
  https://www.bourse.lu/documents/legislation-GOVERNANCE-ten_principles-EN.pdf

- 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

- Circular CSSF 20/759 and 20/758 on the central administration, internal governance and risk management
  https://www.cssf.lu/wp-content/uploads/cssf20_759eng.pdf
  https://www.cssf.lu/wp-content/uploads/cssf20_758eng.pdf

- Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU
  https://www.eba.europa.eu/sites/default/documents/files/documents/10180/1972984/43592777-a543-4a42-8d39-530dd4401832/Joint%20ESMA%20and%20EBA%20Guidelines%20on%20the%20assessment%20of%20suitability%20of%20members%20of%20the%20management%20body%20and%20key%20function%20holders%20%28EBA-GL-2017-12%29.pdf?retry=1

APPENDIX – EXCERPTS FROM ACADEMIC RESEARCH REGARDING EXTERNAL DIRECTORS AND THEIR ROLE

The role of external Directors and of Independence has been written on by many academics. Whilst much of the research focuses on US listed entities (due to access to more data for listed entities), we can see various discussions re-occur across the various research papers. As each jurisdiction has its own laws, culture and other particularities, it is important not to assume unquestioningly research results from foreign jurisdictions (particularly the US) which may not be aligned with or suited to the local environment.

The most common themes relate to economic theories of agency and control and the reduction of agency costs – reflecting their corporate governance function is primarily to monitor management on behalf of dispersed shareholders. These include, in particular, management of conflicts of interest via independence from management and major shareholders, as well as being standard bearers for 'good governance' practices (as is championed by the OECD in its principles of corporate governance)[8].

Like most other countries, Luxembourg company law contains various mechanisms aimed at management of conflicts of interest, including disclosure requirements when faced with opposing interests to those of the company, certain additional checks around contributions in kind, and in some cases additionalrequirements regarding major transactions with related parties. However, these are few and limited in scope, with it left largely to the Board to ensure it is organized appropriately to deal with such issues, with the inclusion of external directors on the Board having become a major tool for this purpose.

Recent research focused on EU Boards

The European Corporate Governance Institute (ECGI) has a wealth of studies available. A recent study focused on Board & CEO incentives[9], concluding that "unlike earlier research that suffered from serious endogeneity issues, current research finds substantial evidence that board independence leads to better manager incentives and enhances shareholder wealth".

For example, several international studies exploring whether shareholders benefit from different types of regulatory-required internal corporate governance standards report that stronger board and audit committee independence improves stock valuation.

8. "The G20/OECD Principles of Corporate Governance" https://www.oecd.org/corporate/principles-corporate-governance/

Overview for example in "New OECD Corporate Governance Reports and the G20/OECD Principles of Corporate Governance" https://corpgov.law.harvard.edu/2021/07/15/new-oecd-corporate-governance-reports-and-the-g20-oecd-principles-of-corporate-governance/

9. "A Survey of Recent Evidence on Boards of Directors and CEO Incentives", Masulis, 2020

https://ecgi.global/news/survey-recent-evidence-boards-directors-and-ceo-incentives

https://ecgi.global/working-paper/survey-recent-evidence-boards-directors-and-ceo-incentives

What is the role of an outside director?

A recent paper on the role of Independent Directors from the US perspective shows the concept continues to evolve and is no longer fully aligned to assumptions and findings in past research papers – confirming one of ILA's findings: independence is not as simple as it sounds, it is often situational, and must continue to be re-assessed.[10]

The Anglo-American view of Independent Directors is, of course, only one of many views of the corporate governance multiverse. A 2017 paper from Singapore[11] looks at the different types of Independent Directors across Asia, adding an interesting contrast to the dominant Anglo-Saxon research. Looking at the meteoric rise of the independent director in Asia, the paper notes significant differences across Asia from the Anglo-American concept of the independent director, with additional variations in form and function of independent directors from jurisdiction to jurisdiction.

As such, there are different varieties of independent directors identified in Asia—and seemingly none of these conform to the Anglo-American concept of the independent director. This challenges the widely held assumption that independent directors are universally similar, and complicates inter-jurisdictional comparisons.

For example, the World Bank uses the requirement for independent directors on corporate boards as one of the metrics in its influential 'Ease of Doing Business Index', which ranks the business and regulatory environments of 190 economies each year. The number of independent directors on corporate boards is also key in influential corporate governance research indices. Yet these all pre-suppose a universal definition and role that is easily comparable, usually defaulting to the Anglo-American model and expectations.

Attempting to overcome this comparative hurdle, the paper identified six factors that have driven the evolution of diverse, jurisdiction-specific, varieties of independent directors in Asia, such as ownership structures, legal origins and political and cultural norms to create a 'loose taxonomy' of the varieties of independent directors in Asia and discusses how an understanding of those variations can help advance corporate governance practice.

Do Independent Directors Improve Firm Performance?

On this topic, research results on the impact of outside directors appears quite mixed and remain inconclusive.

The ECGI paper mentioned above noted "earlier research … suffered from serious endogeneity issues", a possible reason for the mixed and inconclusive nature of the body of research in this area.

10. "What Exactly Is an Independent Director?" Elberg, Laukitis, Mayer-Cesiano, 2022
https://corpgov.law.harvard.edu/2022/03/17/what-exactly-is-an-independent-director/

11. "Varieties of Independent Directors in Asia: A Taxonomy", Puchniak, Kim, 2017
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2930785

A 2015 Stanford 'research spotlight'[12] concluded that the presence of outside directors appears to lead to more rational M&A activity and to higher takeover premiums. They looked at various potential pros and cons, concluding shareholders like to see outside directors on Boards, and react favourably to their appointment (and negatively to their loss/removal). However, whilst outside directors can bring expertise and independence to the board, (reducing agency costs and improving firm performance), outsiders also operate at an information disadvantage that can limit their effectiveness. Overcoming the so called 'information gap' appeared important to the effectiveness of outside directors.

Interestingly they noted that a review of Fortune 100 companies showed 87% of iNEDs were NYSE independent (i.e. regulatory definition), but only 62% were both NYSE and socially independent. They found social dependence to be associated with higher executive pay, and related measures, concluding their results suggest that:

> "social ties affect how directors monitor and discipline the CEO and that, consequently, a considerable percentage of the boards currently classified as independent are substantively not"

and that

> "Shareholders should evaluate director talent on a company-by-company basis to determine their qualification for directorship."

The recent ECGI paper discussed above notes, however, that several international studies report that stronger board and audit committee independence improves stock valuation.

Interestingly, researchers have found there also seemed to be a positive effect of having executives sitting on external boards as independents themselves, giving these executive directors greater visibility and independence from the CEO, and having a positive effect on home firm performance and M&A profitability.

Controlling shareholders – how might these affect the role of outside directors?

A 2011 paper[13] focused on Indian companies states that NEDs, being outsiders not involved in the day-to-day management, bring objectivity to a Board's process in the general interest of the company and of all stakeholders. The paper questions what true independence means in light of various Indian corporate scandals, questioning board composition, and concluded that many such directors were in fact too closely linked to major shareholders and/or management to be able to properly fulfil their role, thereby questioning selection and evaluation processes. In India this was heavily affected by the significant influence of founders or controlling shareholders, even where their stake had since become quite small. It concludes that independent directors can play an impactful role only when board systems and practices enable such role, with timeliness and quality of information provided to NEDs requiring improvement. The paper concludes nonetheless that:

> "Independent directors or non-executive directors of the company monitor and control the chairman/chief executive; they serve as a link with external environment and provide an international perspective. Apart from this independent directors try to improve board processes and bring in specialist knowledge, they provide continuity, help identify alliance and acquisition. It can be concluded that independent directors help maintain an ethical climate in the organization."

12. "Independent and Outside Directors" Larcker, Tayan, Nov 2015

https://www.gsb.stanford.edu/faculty-research/publications/independent-outside-directors

13. "The Role of Independent Directors in a Corporate Governance – a critical evaluation", Kotishwar et al, July 2011, https://www.researchgate.net/publication/293389000_THE_ROLE_OF_INDEPENDENT_DIRECTORS_IN_CORPORATE_GOVERNANCE_-_A_CRITICAL_EVALUATION

It suggests that more attention should be given to selection processes and criteria, including tenure limits and board evaluations as well as strengthening the role of iNEDs by ensuring they are in leadership positions such as chairing the board and committees, as well as use of technology to improve the quality of information.

Further insights into controlling shareholders across the world are set out in a 2014 paper by the ECGI "Independent directors and controlling shareholders around the world"[14], where they conclude that independent directors have a different and relatively narrower role to perform in controlled corporations.

The OECD reports mentioned above also note a trend towards increased shareholder concentration.

Dissent

If outside directors see their role as different when faced with dominant controllers, this raises an interesting conundrum where a controlled firm has accessed outside financing and is listed on capital markets.

An ECGI study based on Italian data indicated directors are less likely to dissent in corporations with more a concentrated ownership structure.[15] With respect to independent directors, dissenting directors were more likely appointed by minority shareholders (generally meaning institutional investors) and in the financial industry.

The study also seems to confirm that separating the positions of chairperson of the board and CEO assists in promoting an active and open dialogue among directors as it appears to result in more 'divergence events' of dissent.

Crisis!! Reputation as a driver in outside director performance and dissent?

Perhaps unsurprisingly, the above research indicated Boards tended to operate less smoothly, and dissent emerged more frequently, when the financial situation was not rosy, as well as in larger and more leveraged corporations.

Does this align somewhat with the research on reputation incentives of directors? A 2017 ECGI research paper[16] has found that independent director reputation incentives influence the supply of director services. These independent director reputation incentives vary across directors and can influence important board decisions and firm outcomes significantly – especially those perceived as important to shareholders. This appeared especially strong in prized directorships (for that individual) where the authors concluded that director reputation affects board decisions and shareholder value by influencing director allocation of effort across their multiple directorships, leading to enhanced shareholder wealth and director reputation in such cases.

14. "Independent directors and controlling shareholders around the world" Ferrarini, Filippelli, 2013
https://ecgi.global/working-paper/independent-directors-and-controlling-shareholders-around-world

15. "Dissenting Directors" Marchetti, Siciliano, Ventoruzzo, 2016
https://ecgi.global/working-paper/dissenting-directors

16. "Independent Director Reputation Incentives: The Supply of Monitoring Services", Masulis, Mobbs, 2017
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2222783

In a similar vein, research shows that negative impacts from directors being temporarily distracted by outside forces (whether due to business or human factors such as family, illness, etc) resulting in reducing their attention to their Boards – and especially to those directorships that they consider less important.[17] The results suggest the independence of distracted independent directors is likely to be compromised as they have to be more reliant on information from company management than their own enquiries.

COVID, and for some the war in Ukraine, are recent examples where distraction may have been great for some directors for, at times, significant periods. During such circumstances, Board leadership is especially important, and various commentators found that management appreciated the sharing of experiences from external directors, especially where Boards 'stepped up' rather than 'overstepped' their remit[18]. In addition, outside directors often helped to ensure focus on planning for the post-crisis future, and not only the immediate crisis.

Mind games: doing the right thing takes more than not having conflicts

A 2013 Oxford/Hamburg paper[19] questioned the definition of independence after the global financial crisis, noting outside directors had not prevented excessive risk-taking and succeeded in increased – or at least more effective - monitoring. Noting that:

> "under the surface of seemingly unanimous consensus about board independence in Western jurisdictions, a surprising disharmony prevails about the justification, extent and purpose of independence requirements".

Given this weakness, the paper concludes that the current system must be questioned and proposes a new, 'functional' concept of board independence to include those directors that are independent of the firm's management and controlling shareholders, and to require them to be more accountable to (minority) shareholders.

We note that the ECB started using the concept of "Independence of Mind" not long after – from 2016 (see more below).

A very interesting study from 2019[20] focused on creating long-term value and Corporate Social Responsibility ("CSR") and the related objectives of the US "Business Round Table", concluding despite hope that the presence of NEDs was "one of the catalysts needed for this change of paradigm for corporations" an analysis of various research studies showed only weak correlations, albeit partially due to non-standardized data and definitions. It describes traditional definitions of concepts such as independence defined as "one that is not subject to another" which are based solely on status and/or context as "first-generation". These are either negative and passive descriptions to define regulatory independence such as "outsider," "non-interested," "disinterested", or contextual approaches such as "independence of mind"

17. "How Valuable are Independent Directors? Evidence from External Distractions", Masulis, Zhang, 2016
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2816470

18. "Board Leadership and Performance in a Crisis" O'Kelley, Fields, Sanderson
https://corpgov.law.harvard.edu/2022/03/25/board-leadership-and-performance-in-a-crisis-2/

19. "Independent Directors: After the Crisis", Ringe, July 2013
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2293394

20. "Understanding Independence: Board of Directors and CSR", Calderon, Pinero, Redin, Dec 2020
https://doi.org/10.3389/fpsyg.2020.552152

as espoused in particular by European institutions such as the ECB (summarizing the evolution of the concept of being an “independent thinker” since its introduction in 2016).

They propose these are incomplete, with a need to be supplemented by more complete definitions encompassing an integral approach of the individual and their moral character. This is because “non-dependence“ does not on its own guarantee the right decision. It must be accompanied by other factors as non-dependence is not always synonymous with being independent.

These second-generation definitions of independence would integrate an Aristotelian perspective of virtue ethics - defining independence as:

> “a virtue guided by practical wisdom, that implies autonomy and autarky and which enables a person to act with integrity, fairness and truthfulness.”

They viewed independence in the context of corporate governance as associated with “an honest disposition to serve” whereby an independent person is:

> “one who has the possibility to present and sustain her opinions without interference or intervention from others.”

Concluding:

> “independence is associated with a set of virtues that reinforce each other in a positive feedback effect. An agent may not be independent without being prudent, courageous or a person of integrity and justice. Hence, a good independent director will strive to render the various stakeholders their due, being moderate in the pursuit and use of resources, and look for the wellbeing of the communities linked to the corporate activity and society as a whole”.

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