

5 September 2002

Mr Derek Higgs
Non-Executive Directors Review
Room 2142
1 Victoria Street
London
SW1 0ET

Dear Derek

It gives me great pleasure to enclose 3i's response to the consultation process for your review into the role and effectiveness of non-executive directors. I do hope that you will find it helpful.

As you would expect we are responding from several points of view. First, as a FTSE100 company; second, as a major institutional investor in quoted and unquoted companies; finally, and perhaps uniquely, as a leader in the provision and development of Independent Directors for unquoted companies, which provides us with a particular understanding of the needs of the people who carry out these roles.

As you will see we feel strongly that there is a considerable opportunity to promote good practice rather than add to the regulatory burden. This is especially the case with regard to the training and development of non-executives but also in the areas of selection, induction and review.

May I wish you every success with your further deliberations and if there is anything more I, Patrick or any of my colleagues can do to help just let me know.

Kind regards

Yours sincerely

BARONESS HOGG
Chairman

**Higgs review of the role and effectiveness
of non-executive directors**

A response from 3i Group plc

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Background to 3i's response

3i is Europe's leading venture capital company with a portfolio of over 2,500 investments across a broad range of sectors and sizes of companies ranging from fledgling start-ups to major multinational groups. These investments are managed through the 36 offices we have in 17 countries.

3i is a member of the FTSE 100 and has been a keen promoter and supporter of good governance over many years. Moreover we have been an active pioneer of best practice in this area. We were one of the original sponsors of PRONED, provided the first training sessions for the European Venture Capital Association on board skills and help to design and deliver courses on this subject for the British Venture Capital Association, Cranfield School of Management and others.

Our Independent Directors Programme has become the leading placer and developer of Chairman and Independent Directors of unquoted companies with over 600 members in 14 countries. These members serve on the boards of about 1200 3i-backed businesses. There are roughly twice as many non-executive directors on the boards of the companies in which we have invested as there were ten years ago. We have also been running events for these members for over ten years, to enable them to develop their knowledge, skills and approaches to the role.

In preparing our response we have relied heavily on our extensive experience of selecting and managing relationships with a wide range of chairmen and non-executives in our investee companies in many countries over many years. We have also sought the views of the executive and non-executive directors of 3i Group PLC, and conducted a survey of the members of our Independent Directors Programme.

We support the concept of a unitary board, although we have experience of other corporate structures. We subscribe to the view that the board is a team, striving to create increased shareholder value whilst maintaining the highest standards of governance and having regard to its wider responsibilities.

We believe that the duties of all directors, whether executive or non-executive, should continue to be the same under company law. However, when assessing any liability for failure to discharge such duties, the differing levels of detailed knowledge of a company's business and operations, and involvement in its day to day management and direction, should be recognised taking into account reasonable expectations of the director concerned.

Our experience is that Independent Directors who command the most respect from the executive are able to have greater influence in the area of governance. Interestingly, this view appears to be supported by those to whom such independence might be supposed to represent a challenge. The CEOs of portfolio companies surveyed by 3i for its latest Enterprise Barometer stressed the value of an independent point of view on the board.

The three areas where we feel there is most benefit to focus more attention on are the following:

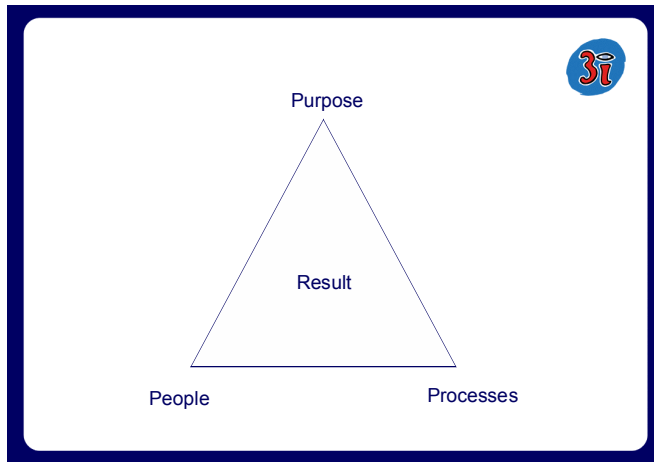
- selection and induction;
- training; and
- performance review.

In response to the questions raised in your consultation document:

A What role should non-executive directors perform, and how does this compare to the present situation?

We believe that the role of the non-executive needs to be put in the context of the role of the board as a whole. We also believe that the board should be viewed as a team with a common set of objectives. A board must have a clear purpose to which the executive, non-executive and shareholders are all committed.

The basic model of board effectiveness we work with is as follows:



Put simply a board with the right purpose, people and processes is likely to get the right result.

The duty of the board is to ensure that:

- there is a robust strategy for the company and for the development of the business and these are regularly monitored and adapted as required;
- the company has the appropriate resources, human and financial, in place to meet its strategy; and
- there are high standards of corporate governance and investor relations

Whilst these are responsibilities of the board as a whole, non-executives play an important role in ensuring that they are fulfilled. This is particularly the case in regard to work that is delegated from the board to sub-committees, for example on the important governance issues of audit and remuneration.

In addition, they can add particular value by

- being a confidential sounding board to the other directors (executive and non-executive);
- bringing an independent and broad view to the board; and

- helping the executive to achieve plans adopted by the board as a whole.

The increasing burden of regulatory and governance responsibilities may lead to non-executive engagement being concentrated in these areas. We believe that it would be regrettable if this happened at the cost of engagement in the development of strategy. Evidence from our own survey (see below) indicates that even in unquoted companies, the proportion of time devoted to corporate governance issues is already significant (23%).

Different types of companies

Within the general framework outlined above, there are clearly significant differences between large quoted companies, small quoted companies, venture capital (VC) backed businesses and privately-owned companies. Whilst we appreciate that the focus of your review is on the larger quoted sector we feel it is important that careful consideration be given to the implications for other types of business of any recommendations that you might make.

We understand that your review team is conducting research into comparisons with other countries. It may also be beneficial to compare board practice under different ownership models – for example, the differences between practice in VC-backed businesses and large quoted companies.

The nature of governance in various types of business will be affected by differences in the following elements:

- The nature and number of shareholders, and the degree of concentration on shareholder powers.
- The balance of executive and non-executive directors.
- The nature of communication with shareholders.
- Shareholder input to board selection and strategy.

In VC-backed businesses, key shareholders may be relatively few in numbers and “locked in” for a period of time. The mechanism for determining governance, apart from company law and general regulation, is principally the investment agreement that VCs and directors sign up to. Communication is relatively easy and frequent, consisting of a mix of the formal and informal. Shareholders are usually closely involved in the selection of directors; the Chairman or a non-executive may have been involved even before a venture capital investment takes place, perhaps helping to assess it, or to set the strategy from purchase to exit. There are usually only one, or at most two, non-executives on the board. (The average number of non-executives on the boards of 3i backed businesses as taken from our current UK Enterprise Barometer is 1.7.)

In larger quoted companies, a Chairman or non-executive may join a company whose strategy is already publicly announced, and whose premise is that significant growth in shareholder value will be driven by earnings rather than a sale of the business. Shareholders may be numerous, diverse and – if the stock is reasonably liquid – changing all the time. The mechanism for determining governance is the combined code. Communication with shareholders is governed by formal rules intended to ensure all of them have equal access to information. Board composition is subject to shareholder approval, but

generally decided by the board itself. Non-executives may equal or exceed the number of executives on the board.

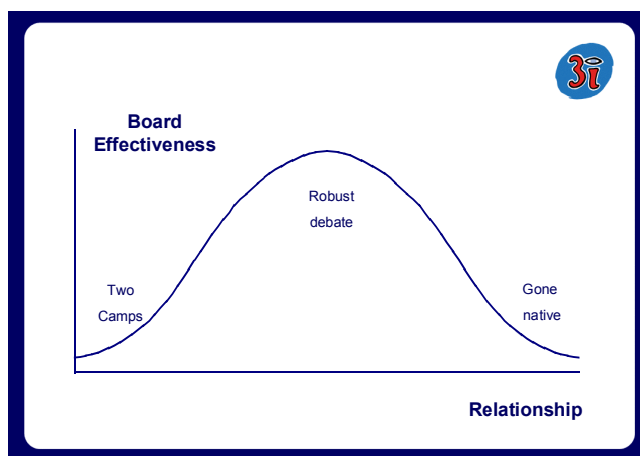
Role of the Chairman

Whilst your review is focussed on the role of non-executive directors in general, we feel it is important to distinguish, and emphasise, the distinct role of the Chairman. Although the responsibilities of non-executive chairmen of board committees, notably remuneration and audit, are clearly becoming more prominent, the role of the Chairman of the company is unique among the non-executives. Putting in place the right procedures to select good Chairmen and deselect bad ones is in our view essential to the effective functioning of the board. In quoted companies, the role of the senior non-executive director is important in this respect.

Broadly, the Chairman's role is to:

- organise the composition, business and efficiency of the board;
- lead the board in the determination and achievement of its strategy;
- ensure that the board has accurate and clear visibility of results and trends;
- ensure that board committees are properly established, composed and operated;
- ensure effective relationships are maintained with all major stakeholders;
- enhance the company's public reputation;
- manage board succession and in particular the appointment of the Chief Executive;
- develop a strong working relationship with the Chief Executive/Managing Director and ensure that there is a clear definition and agreement on the division of responsibilities.

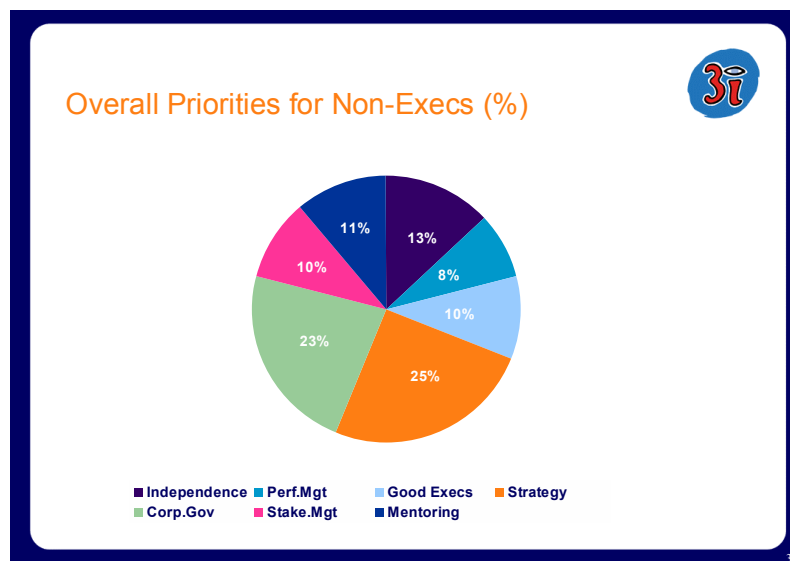
It is also a vital part of the Chairman's role to ensure that there is the right amount of objective debate and constructive tension between the members of the board whether the non-executives are in the minority or not. The graph below illustrates the two extremes that Chairmen need to avoid.



It is of course the Chairman's job to ensure that the board does not slide to one or other end of this spectrum. However, if the directors differ in their views on the role of the non-executives it is a very hard job. There are widely differing views on the role of non-executives, and this review could help establish greater consensus.

Information from our Independent Directors

A recent survey of over 100 of our UK Independent Directors, virtually all of which were sitting on the boards of unquoted companies, showed how they saw the balance of their role. These averages however conceal quite wide differences in the perceptions of individual non-executives.



B What knowledge skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?

The knowledge, skills and attributes needed vary considerably by type of company. For the businesses in its portfolio, 3i draws heavily on its Independent Directors Programme - a pool of pre-qualified candidates who have been through a recruitment and referencing process and have a track record on the boards of these types of unquoted companies. Other VCs tend to use professional search firms to source candidates, which indeed 3i will do from time to time.

In considering the core competencies we require of Chairmen and Independent Directors we place particular emphasis upon judgement – with respect to people and commercial situations - interpersonal skills and motivation. Our Independent Directors must also have the ability to recognise a conflict of interest and the skill to deal with one when it arises.

We also believe that non-executives should have the ability to subscribe for equity or, where this is appropriate, receive shares in lieu of payment. In our venture capital backed situations we would expect them to do so. We are, however, inclined to restrict the use of options for non-executives to rescue or start up situations. In other situations, we believe purchase of equity is the best way to ensure an alignment of interest.

At 3i we would normally expect the members of our Independent Programme to be

financially independent when they join the programme. They are then not dependent upon the income they receive from any single appointment, and should be able to take a personal stake. However, this inevitably restricts the pool of potential directors, and may well not be appropriate for other types of companies.

Quoted companies

The recruitment processes for non-executive directors of large quoted companies are rather different. As noted above, they are unlikely to involve shareholders directly, although appointments are subject to shareholder approval at the annual AGM. The selection process is in the hands of the existing board. As the balance of boards has changed, with an increasing proportion of non-executive members, nomination committees of the larger boards normally consist largely of non-executives. The committee is usually chaired by the company Chairman, or Senior Non-Executive Director.

In smaller quoted companies, with fewer non-executive directors, the influence of executive management may be greater. The use of search firms to identify suitable candidates has increased greatly, although smaller quoted companies may still be reluctant to incur the expense.

The Chairman of a large quoted company will, like the shareholders in a VC business, be looking to “add value”. However, rather than seeking to identify a single individual, chairmen of quoted companies will be looking to add to the range of different skills and experience of a larger group of non-executives around the board table. This means that on different occasions they may be looking for financial expertise, relevant industrial experience, regulatory knowledge/experience, a specialist contribution (such as on economics, strategy, marketing, investor relations, legal or HR) or senior management experience in another company. Increasingly, Chairmen will also be looking to widen the international mix of the board. And from one or more of these, Chairmen should be looking to bring on to the board potential successors.

Two issues with respect to recruitment perhaps merit further comment:

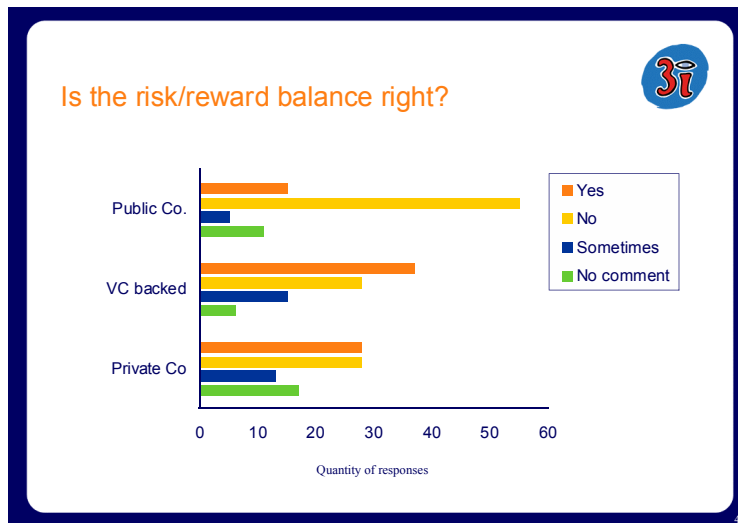
- Is there a shortage of potential non-executives?
- Are selection processes sufficiently wide-ranging?

Opinions differ as to whether there is a shortage of good non-executives, in a climate in which the risks are perceived to be increasing and the rewards relatively modest. Our experience is that there is a massive supply of aspirants and a large pool of potential talent but the match between the aspirants and the demand is far from perfect.

While there may – so far – have been little difficulty in attracting candidates for the biggest and best FTSE companies, in general this may be getting harder. In particular, there may well develop an increasing problem in attracting good quality non-executives to the boards of smaller quoted companies, or quoted companies in difficulties, if the regulatory responsibilities become too great. The chart below, drawn from our survey of 100 non-executives conducted in July 2002, illustrates the different perceptions with respect to quoted and unquoted companies. The key point we feel is that the job is becoming more difficult.

A copy of our annual Independent Director and Chairman survey (produced in association with Top Pay Research group) is contained in Appendix 6. This survey also contains views on a whole range of other non-executive issues.

This survey and others provide some of the answers as to why a PLC appointment has become less attractive. Reputational risk, a hostile media, time commitment, low rewards and increasing time on governance at the expense of other issues are the typical reasons given for this view. Concerns about the extent of legal responsibilities, and about the adequacy of directors' liability insurance, have undoubtedly increased the wariness of potential directors. In summary: more risk, less reward and less fun.



By comparison, VC-backed situations, in which an Independent Director can take a stake in an unquoted company, and where the regulatory burdens and pressure from the media are so much less, may seem relatively more attractive. On the other hand, the workload can be considerable, as can the risk of failure. At 3i we are fortunate that because of our Independent Directors Programme we do not find supply a problem in the UK. It is, however, still an issue for us in some other countries.

Our impression is that the search for appropriate non-executives has become somewhat more wide-ranging and – at least amongst major companies – professional. For example, the desire to make UK boards more international is leading to the recruitment of non-executive directors from the United States, continental Europe and the Far East. However, there is still, perhaps understandably, some tendency to “play safe” by appointing from amongst a small cadre of experienced non-executives or well-known names. In part, this may reflect the expected reactions of institutional shareholders.

In particular, more could perhaps be done to tap the pool of talent amongst executives, for whom an outside appointment to a company board can be of great mutual benefit. This might also help to increase the (still low) proportion of women on company boards. We return to this point under training.

Remuneration

We believe that while it remains true to say that most non-executives do not “do it for the money”, being attracted either by the status or intrinsic interest attached to membership of

the board of a major company, they should be appropriately rewarded and have their rewards aligned with shareholders.

The basic remuneration should be related to the time commitment involved, the responsibilities undertaken and the size and nature of the company. There is an increasing and appropriate trend to reward the chairmen of the main board committees significantly more than other non-executives. In association with the Top Pay Research Group, 3i publish an annual survey to help directors benchmark basic remuneration. A copy of this is attached as appendix 6. We have already noted that the opportunity to take an equity stake is an important attraction to the board of a VC-backed company. We also believe that directors of quoted companies should be encouraged to acquire and hold shares in those companies on whose boards they serve.

C. Do existing structures and procedures facilitate effective performance by non-executive directors?

Our overall view is that much has been done to improve the structures and procedures of boards since the Cadbury report a decade ago. We do not believe that there is a need for additional legislation or regulation in this area.

We believe that the present combined code for listed companies does facilitate effective performance by non-executive directors. The separation of Chairman and Chief Executive roles has been helpful, as has the establishment of the role of the “senior independent director”.

The roles of board committees especially audit and remuneration has received much attention and we have no further comments to add here. We do however feel that some guidance on best practice for nominations committees might be helpful, providing an opportunity for improvement in selection processes for non-executive, Chairman and chief executive appointments.

It might also be helpful to find ways of spreading best practice with respect to boards’ reviews of their own effectiveness. It will be important, however, to understand the need to spread knowledge, rather than create another box-ticking exercise. We return to this subject under section E. Meanwhile, the important role that the Company Secretary can play in advising Chairmen on this should be noted.

We believe that the current flexibility with regard to the number of non-executive appointments that an individual may have is helpful. The pressure of disclosure is now sufficient to deter the over busy. We would be concerned by the introduction of any formal limit as in our view the widely differing time commitments these roles entail makes it difficult to come up with a sensible number. Moreover, since the extent of a director’s other involvement would have to be taken into account; formal limits might prove unnecessarily damaging to the charitable and public sectors.

A balance has to be struck between a plurality that enhances a director’s board contribution – bringing perspective, independence and experience – and a multiplicity that gives rise to problems when crises demand a great deal of a director’s time. Together with potential conflicts of interest, these are issues to be resolved by companies on a case-by-case basis in active reviews of a director’s effectiveness.

D Do existing relationships with shareholders or others need to be strengthened?

Here too, there are clearly considerable differences between the FTSE, Small Cap companies, VC backed businesses and small private companies. In small private companies, the shareholders and directors are usually the same. In VC backed businesses there are relatively few shareholders, and the institutional ones have a direct and active relationship. 3i is particularly fortunate in this regard as the IDP provides us with the additional benefit of a longer-term relationship across a number of different situations.

In quoted companies, particularly larger companies with a wider shareholder base, the situation is clearly different. We welcome the fact that your review team is considering the role that institutional shareholders should play in ensuring good governance (including setting a good governance example themselves). There is a clear need to spread greater understanding of board functions amongst institutional investors.

At 3i we have run a case study session for analysts and institutional investors to give them an insight onto the issues non-executives face in our investee companies. They found this very educational and there was some comment about the need for more of this (e.g. PLC based) in training for analysts.

The desirability and practicality of separate meetings between institutional shareholders and non-executives is a matter of increasing discussion. It clearly is appropriate that institutional shareholders should seek to reassure themselves as to the governance of the company. At the same time, it is also important that regular channels of contact on the company's performance are not duplicated or confused.

A suitable balance has to be maintained. Institutional shareholders may, for example, wish to speak to the chairmen of remuneration committees about new executive reward schemes. And at a time when major transactions are taking place, it is appropriate and even necessary that non-executives should be prepared to explain their position to major shareholders.

E How can non-executive directors best be supported to perform their role?

The key issue here is training, although we also comment on the title and status of non-executives below.

Training for non-executive directors remains patchy. 3i provide extensive training for the directors of unquoted companies through its Independent Directors Programme, but there is no comparable wide-ranging programme for the potential directors of major quoted companies. Most major companies now provide induction programmes for new directors, but disappointingly little is available in the way of good quality independent training, and this undoubtedly acts as a blockage to the flow from the pool of potential talent. Membership of another board is often seen as the best (indeed the only) effective preparation for a directorship.

This problem is reflected in the attitude of a number of non-executives of the old school. There is still a feeling amongst some that they don't need training. *"After all I'm being recruited for my experience. To ask for training may convey the impression that I'm not up to the job."* Additionally they may feel there is the potential to be embarrassed. Many also fail to appreciate the difference between executive and non-executive roles and sometimes

make the assumption that just because they have been a good executive they will be a good non-executive.

There is also little training or education about boards within management training or professional qualifications. This is an important issue not just for those who will become non-executives but for the larger number of people in business who will be on boards and work with non-executives. There is also a gap in the market for some simple guides on selection, induction and a whole range of other board topics. Finally, any discussion of training should not neglect the need for greater training of institutional shareholders and analysts, to enhance their understanding of board and governance issues.

There are a number of fairly obvious things to be done to improve the situation for the longer term. For example, it should be straightforward to include modules on "board skills" in business studies degrees, the professional qualifications, MBAs and so on. 3i has supported work to include such modules as part of the Cranfield MBA and the London Business School Senior Executives programme. Further emphasis on senior courses might help to encourage management to take on non-executive roles in other businesses. We gather that at Harvard Business School there are now five electives on the MBA programme relating to the operation of boards and corporate governance. The educational toolkit that has been developed for universities by the European Venture Capital Association may be an example of the way forward.

For the present generation, the solution is not to set up compulsory courses for non-executive directors, but for bodies of high reputation to encourage an improvement in the quality of training by "kitemarking" courses at the best business schools. For new non-executives without board experience, too, it would be helpful to have access to advice before taking on a directorship, as to the best way in which to conduct the necessary due diligence.

Some argue that the non-executive director's role would be enhanced if the name were to be changed. We have explored this issue and found little consensus. Amongst the directors surveyed by 3i, there is some appetite for the term "Independent Director" but only if the problems involved in defining independence could be resolved, in ways that did not undermine the cohesion of the board.

Summary

We welcome the review and look upon it as an opportunity to improve performance in a key area. We believe the key objective of the review should be to identify ways of spreading best practice without imposing new regulatory burdens on boards. This would be counter-productive, by discouraging able people from serving on boards, and thus narrowing the pool of available talent rather than widening it.

Sample of event themes for 3i independent Directors Programme

How do I know a good FD when I see one?

Independent directors are critically dependent upon the quality of the Finance director and the relationship they have with them. This case study based event explores the subject through a mix of sharing best practice and role-plays including a mock interview between an independent director and FD. This event has been run throughout Europe and has proven highly popular.

Coaching CEOs and MDs

Through a series of exercises the independent directors develop what they feel are the core competencies to look for in CEO in a range of different contexts (e.g. start-up, major international group). Then through a series of short case studies they are presented with some real life difficult situations (some of these are contained in "Directors Dilemmas").

The role and contribution of Independent Directors

Aimed principally at those transitioning from executive to non-executive roles or where 3i is pioneering practice in a new country (e.g. Japan, Finland, Denmark etc). This event explores the different aspects of the role using experienced practitioners.

Selecting Independent Directors

An event based on role reversal. Here the Independent directors are put in the role of the management of a buy out company and they have to design a selection process, sift through potential candidates cv's, role play interviews with potential candidates and design and induction process.

Managing Board Disharmony

A case study based event, which explores some principles for dealing with board disharmony, and then role-plays some very difficult situations.

Removing Directors

A case study based event, which focuses on the process for removing a director in the most effective way. We use role-play and include a legal advisor. A checklist is then provided (this is contained in Directors Dilemmas).

Financial Structuring

An event focussed on the financial structures used in VC backed situations (e.g. buy outs and start-ups). Experienced practitioners explore range of issues from the basics of developing the right funding strategy to detailed exploration of the pros and cons of different financial instruments, restructuring and so on.

Board performance and review

How do you know that your board is doing a good job and how should you go about designing performance reviews for individual directors. Case study based.

Strategy

An event based around a play developed with the programme's members. This explores the independent director's role in forming, monitoring and adapting strategy and some of the latest models and frameworks for doing so. The play is in three acts with pauses for audience participation!

Choosing, Using and Abusing Search firms

This event looks at the relationship between the board and search firms during the appointment of a key board member. It covers how to select them, ensure they do a good job and so on.

Internationalising a business

Almost all of our members and portfolio companies have international experience or activities. This event looks at approaches to developing an international strategy, market entry strategies and the management issues managing an international business successfully.