

BT GROUP plc

Response to the consultation paper “*Review of the role and effectiveness of non-executive directors*”

A Role.

In considering the role to be performed by non-executive directors (NEDs) our starting point is that the UK continues with the current legal position that all directors, whether executive or non-executive, share the same legal duties and obligations. They are all equally and jointly responsible to a company’s shareholders and other stakeholders for the manner in which the company is managed, its performance and for its compliance. In this context, we believe that the key issue for this review is to consider the effectiveness of boards rather than of just the non-executive directors.

We support the recommendation of the Company Law Review and the recently issued Government White Paper on Modernising Company Law that there should be a single statement of directors’ duties which applies to all directors and does not differentiate between executive and non-executive directors.

If all directors have the same duties and responsibilities it follows that in broad terms it is the role of the board, not of a part of it, such as the NEDs, to:

- set strategy and direction
- monitor performance (and agree remedial action where needed)
- manage communications with shareholders (and the wider investing community)
- ensure legal, regulatory and all other relevant standards of compliance and governance.

To deliver this role successfully the board must:

- be led by a strong Chairman who commands the trust and respect of the other directors
- comprise a balance of executive and non-executive directors. We support the generally accepted practice of there being a majority of NEDs whom we believe should be independent of the company.

We support that in normal circumstances the roles of Chairman and Chief Executive should be separated.

The Chairman forms the essential “bridge” between the executive and non-executive element on the board. His role, in addition to leading the board as a whole, ensuring effective use of its time, promoting constructive discussion and relationships, encouraging effective and constructive contributions at meetings from the NEDs and that the board fulfils its role, is to:

- seek and evaluate the views and recommendations of the NEDs outside the formality of board meetings on key issues
- assist in reconciling any differences of view of the executives and NEDs
- facilitate the exchange of ideas between the management team and the NEDs
- ensure effective senior executive succession planning.

To discharge this role effectively we believe a Chairman should devote at least 2 days a week to the Company.

Turning to the NEDs, current governance standards place upon them a role to:

- comment on and input to the development of a company's strategy and monitor implementation and delivery of the agreed strategy
- review and monitor the performance of company's senior executive team
- safeguard the interests of shareholders and other stakeholders by ensuring that those interests are given proper attention when business decisions are taken, that conflicts arising between executives' personal targets and the company's best interests are identified and dealt with and through such bodies as a company's audit committee
- agree senior executive remuneration
- bring independence of thought and action to their decisions and to the decisions of the board.

This is in addition to the commercial aspects of their role, such as bringing specific experience, skills or knowledge to the board which are otherwise lacking or not sufficiently represented.

This is a challenging and time-consuming role. No one NED can or should be expected to bring every aspect of the commercial requirements to the board. However, we believe all NEDs must be aware of all the governance issues affecting a company, free to and encouraged to join in discussion of them and, at board level, responsible for effective and compliant governance by the company.

Effective NEDs need also to devote time to a company outside the formality of board and committee meetings. They should be encouraged to develop, individually and collectively, informal contacts with a company's auditors and other professional advisers as other sources of information on a company's issues. Such contacts should, however, be only for the purpose of obtaining a greater understanding of the company and accounting or other issues dealt with by the advisers. NEDs should also develop channels to meet, again informally, a company's employees, customers and suppliers.

Such a demanding role requires a minimum of 2 days a month (more in the first year of appointment) from each NED.

Many NEDs will be combining non-executive appointments with top level executive roles in industry or the public sector. There is also a growing band of people who carry out only non-executive roles. The differing natures and demands of every one of these roles suggests a hard and fast cap on the number of non-executive appointments any one person can hold at the same time will fail to cover every

situation. We do support, however, some limit on the number of non-executive appointments that a person should hold simultaneously. In the case of CEOs or other senior executives a suitable limit is certainly no more than two non-executive appointments. In other cases the ceiling should be set no higher than 5 or 6 appointments. Any limits should, however, be recommendations only so as to allow a company, through its nominating committee and ultimately board, and an individual non-executive director the flexibility temporarily to work above such ceilings where the circumstances are appropriate.

The recommendations of the Hampel Review, taken into the Combined Code, brought forward the concept of the “senior independent” NED. In cases where the role of Chairman and CEO are combined or where there is a part-time Chairman engaged fairly intensively in a company’s activities, we see the advantage of such a role. It provides a focal point for the NEDs and a principal (but not solitary) point of contact between the NEDs and the Chairman. It should not, however, provide a “back door” for contacts between investors and the company. These should be maintained through appropriate relationships between, for instance, the chairman of the remuneration committee and key institutional investors. The senior independent NED should never be seen as an alternative power base within a company.

B Attracting and appointing non-executives

The paramount reason to recruit non-executive directors must remain bringing to a board their skills and experience to assist in improving the company’s overall performance and therefore the benefits to its shareholders, employees and other stakeholders. We would not support changes to the governance environment that placed the governance element of the NEDs’ role above their commercial input to a company.

The governance role placed upon NEDs since the Cadbury Report demands, however, a separate range of skills, attributes and personal qualities. Key amongst these are:

- independence from the company (in terms of any material financial dependence, current or recent former major commercial or contractual relationships, past employment or close familial or business relations with or dependence on a member of the company’s senior executive team),
- independence of thought,
- financial literacy.

These are essential for all independent NEDs. In the case of a company’s audit committee at least one, preferably more, of its members should also have a more formal financial background although we would not support the idea that this should be limited to possession of a formal accounting qualification.

In our experience, the level of remuneration has not hitherto been a problem in finding good class candidates. However, this may change given such recent events as the suing of past Equitable Life directors, Enron, Worldcom and Tyco. Current levels of reward may not be seen as adequate to balance the higher potential risks

that come with being a director. Levels of reward may therefore need to be reviewed. We feel the pressure will be for meaningful increases in directors' fees. Companies may also face pressure to provide adequate levels of directors' and officers' liability insurance at a time when capacity in the insurance market has reduced and markets may seek to restrict the availability of cover for liabilities arising from alleged disclosure and reporting failures. We believe, however, that it is dangerous to place reliance on insurance as anything other than a safety net for NEDs. It is more important that companies demonstrate openly adherence to good corporate governance standards and practices to candidates as NEDs, that NEDs as a whole, and particularly audit committees, robustly question executive actions and decisions and financial information presented to them and that, in appropriate circumstances, NEDs instigate remedial action.

We would not support short-term incentive arrangements for NEDs. Part of their function should be to take a longer-term view where management is not doing so and this may be prejudiced if they are incentivised over the short-term.

The method of selection and appointment (ie the use of a nominating committee and professional "head-hunter") is not a limiting factor on the ease with which NEDs with the right skills, etc can be recruited. Neither can we see how changes to the current process would either make recruitment easier or open up a wider or deeper NEDs' pool. Opening up a wider pool of potential NEDs is, however, a priority. In this respect, we see the need to provide the opportunities and incentives to attract younger candidates who can bring the commercial input to boards as well as possibly more innovative (or, looked at another way, less traditional) approaches to issues. Upward movement on non-executive remuneration may help to attract this new source of NEDs by providing a better balance of reward and risk to people at a point in their careers when the risk and commitment, when building a career elsewhere, may not otherwise be attractive.

C Structures and accountability

The keys to the effectiveness of NEDs are:

1. Independence from the company
2. Independence of thought
3. Robustness
4. The provision of adequate information by the company in a timely manner
5. Board and committee structures which encourage and support transparency of information and open discussion.
6. Sound relationships with the Chairman and CEO, based on mutual trust and respect.

Taking each in turn.

1. The working practice must be that all NEDs are independent from the company. Current definitions of independence are perfectly adequate.
2. NEDs need to bring a questioning and constructively critical attitude to the issues before them. It is very clear that they are not expected merely to

rubber-stamp executive decisions or accept without questioning all information given to them by a company.

3. Achieving 2 above is dependent on the ability and willingness of NEDs to question. Those NEDs who proactively seek information, whilst considering an offer to take up a post and during their tenure in office, are more likely to take a robust approach and will be better placed to do so. We support companies making key information available to candidates as NEDs and arranging meetings with key executives (subject to the normal needs of commercial confidentiality and share price sensitive information).
4. NEDs by the nature of their role are not involved in a company on a day-to-day basis and will spend only a part of their working time on a company's affairs. They can only perform effectively if they are provided with all the information they need, when they need it. This will be not only for board and committee meetings but also at other times, particularly when major issues are being dealt with. The Chairman has a key role in determining with the NEDs the form and content of regular information provided by the company and the Company Secretary an important task to ensure that information is provided as and when needed. The Company Secretary must also support the Chairman in ensuring that appropriate issues are brought to the NEDs' attention and their input is obtained. We have already in answer to Section A commented on NEDs also engaging with a company's auditors, external professional advisers, employees and other stakeholders.
5. Boards should comprise at least a balance of executive and non-executive directors. We support the generally accepted practice of there being a majority of NEDs and, in normal circumstances, all the NEDs being independent. The size of a board will be determined by each company and if it is properly chaired and supported, size should not impair its effectiveness. We would err towards boards for large companies of between 10 and 12 members. Audit, remuneration and nominating committees add to the overall effectiveness of the board and the NEDs by allowing detailed discussion of relevant business at dedicated committee meetings, with reports from the committees' chairmen to the whole board of the key outcomes of the committees' meetings, thereby freeing board time to concentrate on wider issues and a company's overall performance. Appropriate relationships between each committee's chairman and relevant executives and key external advisers (eg auditors, recruitment consultants) is key to the success of these committees. The Company Secretary must retain close contact with the committees' chairmen to ensure all appropriate business is considered. We would not recommend changes to the duties of any of these committees. We support members of the audit committee being financially literate and a move towards a more formal financial background for at least one, preferably more, of the members of audit committees.
6. The effectiveness of the NEDs will be diminished if they do not have sound relationships with the Chairman and the CEO. The absence of such relationships may lead to divided boards.

In the above respects, we believe the Combined Code is working effectively. The proper operation of the Code should enable NEDs to challenge successfully executive decisions or to expose serious problems. If this is not always the case, improvements may be needed to one or more of the keys given above.

The Company Secretary has an important role in ensuring the effectiveness of governance procedures. He/She should be in the position to ensure the proper and timely flow of information to boards and their committees, to all directors, particularly the NEDs, at other times and to assist a company's Chairman and committee chairmen in the effective use of the board's and committees' time. He/She should also be able to support the effective contribution of the NEDs by advising the Chairman on issues that should be brought to the NEDs' attention. In addition to internal matters this should include changes to the external environment, regulatory, legal and corporate governance issues. We support the Combined Code provision that the appointment or removal of the Company Secretary is a matter for the whole board. We would support this being made a statutory provision and the codification of the role of the Company Secretary.

Cadbury and the Combined Code require a process for NEDs to be able to take independent professional advice at a company's expense. This can help towards effective delivery of the NEDs' role but we believe should be used by NEDs sparingly. The relationship of trust and respect between the executives and the NEDs may be damaged if it became common practice for NEDs to seek external advice on all issues. The Company Secretary should act as the channel through which such contacts are arranged and payment agreed.

Boards should be encouraged to assess their performance. It would not be divisive in our opinion if every director had the opportunity to comment (anonymously if wished) on his/her board colleagues to the Chairman and the Company Secretary. Unless commonly understood and applicable measures of board performance and effectiveness can be developed for listed companies we doubt, however, the value of reporting on this aspect to shareholders.

D Relationships with shareholders and others

NEDs have a key role to play with a company's shareholders (and can play a significant supporting role to the executive in respect of other stakeholders, particularly government, regulators, major customers and major suppliers). However, except for the:-

- chairmen of remuneration committees, who should have access to and be accessible to major shareholders and investor groups, such as the ABI and NAPF
- audit committee chairmen, who should develop close links with a company's external auditors and have access to and be accessible to a company's internal audit function, where this exists

NEDs should not have any special relationship with shareholders, either as a whole or from particular investing backgrounds. We believe this is contrary to the UK legal

principle that all directors are accountable to and should take account of all shareholders and their interests and may be divisive. We do not support some NEDs being directly nominated and elected by the shareholders or the annual re-election of all NEDs by the shareholders. The former would, in our view, weaken the concept of the unitary board and create an unnecessary possible source of tension between the various board elements (ie executive, board nominated NEDs and shareholder selected NEDs). The latter may result in a smaller NEDs' pool as people would be unwilling to take the responsibilities and commitments of a NED against the backdrop of uncertainty over tenure of office for a reasonable period of time.

The chairmen of audit and remuneration committees should be encouraged to answer shareholders' questions at companies' annual general meetings.

We have covered in our response to sections A to C issues about (a) the role of Chairmen, (b) the relationships between NEDs and Chairmen and CEOs and (c) the support that should be encouraged from the Company Secretary.

E Support

We have already commented on the need for adequate and timely information to be available to NEDs if they are to be effective. The information given to them should (a) be agreed with them and (b) regularly reviewed by them for adequacy, accuracy, and timeliness. We have commented already on the pivotal role of the Company Secretary in (a) the provision of information, (b) its review and (c) ensuring transparency and openness.

All NEDs should be aware of the key legal, compliance and regulatory obligations attached to their role and affecting the company. In our experience, the former is fairly well understood, although the advent of the Competition Act and FSMA places higher demands on all directors and they should be encouraged to understand the impacts and consequences of these Acts in particular. We provide a wide range of briefing material and meetings to NEDs on appointment and throughout their tenure in respect of the latter training aspect. We believe all companies should look regularly at the induction given to NEDs.

F Smaller listed companies

We believe good governance and effective NEDs should apply to all listed companies. The principles and provisions of the Combined Code should apply to all. The key issues we have pointed out on the role of the board, chairmen, the skills and attributes required of NEDs and in respect of board and committee structures and practices should apply to all listed companies.

G International context

It is generally acknowledged that UK corporate governance has been developed ahead of the other major industrialised nations. This does not mean that we cannot learn from their institutions and practices to improve our governance standards. However, we see no demonstrable benefits in, for instance, a two tier board system or in the presence of organisations such as the Securities and Exchange Commission. What we can learn from international experience is where their systems have failed them and why and then to review our system to see if the same could happen in the UK.