

Tower 3
3 Clements Inn
London WC2A 2AZ

T 020-7025 2950
F 020-7025 2951

bvca@bvca.co.uk
www.bvca.co.uk

04 September 2002

Non-Executive Directors Review
Room 2142
1 Victoria Street
London SW1H 0ET

Dear Sirs

We refer to the above review and set out below the response of the BVCA to the Consultation document dated 7 June 2002.

Background on BVCA

The BVCA represents the vast majority of private equity and venture capital in the UK. We have over 160 full member firms active in making long-term equity investments in unquoted companies. We also have over 150 associate member firms, including lawyers, accountants, banks and academics, which have close links with the private equity industry.

During 2001 our full members invested over £6 billion in new and developing businesses within the UK. The UK private equity industry is the largest and most developed in Europe. Private equity-backed firms in the UK employ over 2.7 million people and contribute nearly £30 billion to public revenues each tax year.

Reasons for Response

Although the primary focus of the Review is on listed companies, the BVCA felt it appropriate to respond for a number of reasons:

1. To try to make a sensible and worthwhile contribution in an area of public concern.
2. There may be practices common in the private equity industry that would be helpful in a wider context.
3. As an industry we probably appoint more Non-Executive Directors (NEDs) than any other industry or group. Our members typically make about 1500 new investments each year. In the majority of these cases at least one NED appointment will be made and often two. So on a continuing bases our industry probably makes 2000 – 2500 such appointments each year.



4. As a result of the success of our industry we have a strong interest in the governance of quoted companies because we are frequently preparing private equity backed businesses for flotation and often retain significant holdings in such companies post flotation.

Private equity NED Appointments

These normally take two forms usually operated in parallel.

- Internal Appointments - On completion of a private equity investment the private equity firm will often have the right for one of its own executives to be a NED of the investee company. It is usually the executive who has been responsible for making the investment and who has therefore already established a relationship with the management team and has been heavily involved in the extensive due diligence carried out prior to making the investment.

Such executives will often have a number of NED appointments in addition to their duties as an employee of the private equity firm. To hold three or four such appointments is not unusual. Although these executives have all the duties and responsibilities of any other director, they are usually perceived as representing specifically the interests of the private equity firm as a shareholder.

Occasionally, though not frequently, the private equity executive will act as chairman of the investee company.

- External Appointments - In addition to, or sometimes in place of, the internal appointment referred to above, the private equity firm will often appoint or be influential in appointing a completely independent NED and/or chairman to the board of the investee company.

Private Equity Company vs. Quoted Company

There are a number of essential differences between the two.

- Governance - Quoted companies are usually governed by their own memorandum and articles, company law and various codes or regulatory requirements.

In private equity backed companies the Articles of Association are much more detailed and/or there is a separate Shareholder Agreement covering in much more detail what the board is obliged to do and what actions require shareholder approval. This shareholder approval is sometimes delegated to the NED(s) or is monitored and communicated by them. An example list of common provisions in private equity transactions is attached as Appendix I.



- Shareholder Involvement - In quoted companies the shareholder/company or shareholder/management relationship is generally very arms length.

In private equity backed companies the private equity firm will usually have a significant minority or even a controlling shareholding in the investee company. This facilitates not just communication but also allows the involvement in governance and control outlined above.

It also extends, where necessary, to rapid and decisive action being taken where the executive management of a private equity backed business are not performing satisfactorily.
- Exit Planning - Quoted companies generally continue in existence as independent entities, albeit with a constantly changing shareholder base, for as long as the shareholders are content and no bid emerges.

In private equity backed companies there is often a pre-determined plan to exit within a given timescale and this frequently forms part of the role of the NED(s).
- Terms of Appointment - We clearly have limited experience of the Terms of Appointment of directors of quoted companies but attached at Appendix 2 for your interest are some examples of letters of appointment for NED/chairman positions in the private equity industry.

We now turn to the seven key areas covered in the review itself.

A. Role

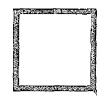
What role should NEDs perform, and how does this compare to the present position?

The role of the NED in private equity backed companies is demonstrated by the governance elements and letters of appointment set out in Appendices 1 and 2. Some of the roles specifically commented on by our members include:

"Corporate governance, strategy, coaching executive management, succession planning".

"The role of the board is to ensure that the company is being managed for the benefit of all shareholders, and to a lesser extent other stakeholders. The chairman and NEDs are the guardians of that guiding principle".

Probably the overriding comment on the role of NEDs is that it requires to embrace performance monitoring, governance and strategy. The perception is that private equity backed companies place a much greater emphasis on monitoring and governance.



B. Attracting and Appointing NEDs.

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

Some sample responses are attached as Appendix 3 and some special examples of cases where NEDs have contributed with particular effect to company performance, or to corporate governance, are attached as Appendix 4.

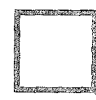
If we focus in particular on the area of key skills, knowledge, experience, personal qualities and attributes then there are some key themes that emerge:

- Track record of success
- Management experience
- Sector knowledge
- Independence
- Financial independence
- M&A experience
- Judgement
- Gravitas
- People skills;
- and a variety of others.

People of the right quality are very difficult to find. Comments from a number of our members are that there are NEDs who approach our industry who want to be "paid for turning up once a month and offering a few wise platitudes" or that they have come across situations (in some quoted companies) where NEDs are appointed either because they are "mates of the executives" or they are "forced into the role by the cessation of their executive career".

The most quoted response is that if it is necessary to increase the number of good quality NEDs, then the risk/reward ratio for such appointments needs to be shifted quite significantly. At present NEDs face potentially financial, criminal and reputational risk in return for what, other than in very large quoted companies, is quite modest financial reward. Many of our member firms "reward" NEDs with salary, bonus, options, shares etc often linked to performance and, in our industry, often specifically linked to a successful exit. There are differing views as to the suitability of options vs shares or shares vs remuneration and there are also caveats about the level of reward not being such as to jeopardise impartial judgement or independence. Nonetheless the overriding view is that current financial rewards in quoted companies are insufficient to attract significant numbers of high quality people.

Most of our member firms do support the provision of D&O cover by investee companies for the board including NEDs. A number of comments have been made that anybody joining a board without D&O cover probably shouldn't be a NED anyway.



C. Structures and Accountability

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

The comments that have been made in this area include a **maximum** effective board size of ten people with a number of smaller figures quoted and that the various committees i.e. audit, remuneration and nomination should at least have a majority of NEDs and a NED chairman. Our members generally wholeheartedly support the concept of a unitary board.

Some more detailed practices adopted by our members, include;

- NEDs being allocated specific areas or divisions within a company to review.
- Encouragement to do regular site visits and meet second tier management.
- For there to be direct access between auditors and audit committee.
- For the audit committee to see all drafts of management letters provided by the auditors not just the final version.
- NEDs being allocated an expenditure budget to allow them to commission work e.g. salary reviews and executive incentive schemes independent of executive management.
- NEDs being required to report to shareholders either formally or informally on e.g. management performance, strategy and succession planning.

D. Relationships with Shareholders and Others

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

As is apparent throughout our response in the private equity industry the relationship between NEDs and shareholders is much closer than in quoted companies. This is of course hugely facilitated by the fact that the private equity house will usually have a significant minority or even a majority holding in the company concerned and will frequently have an executive of the private equity firm sitting as a NED on the board of the investee company.

Any strengthening of the relationship in the quoted sector is dependent on action taken by the companies concerned but equally on the reaction of institutional shareholder attempts to involve them more fully. The suggestion under C above that NEDs be required to report to shareholders, either formally or informally, on e.g. management performance, strategy and succession planning may be worth further consideration.





E. Support

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

It is worth highlighting some of the practices in the private equity industry that we regard as effective.

- NEDs generally in our industry have the authority and standing to access any information they require and are encouraged to visit sites, meet second tier management and often maintain a continual dialogue with e.g. the Chief Executive, Finance Director and other key executives outside the normal, formal board meetings.
- The letters of appointment we use (examples in Appendix 2) set out clearly and in detail what is expected of them and feedback would generally be given, at least annually, from the private equity firms as to how they were performing.
- On training and development the BVCA determined some two years ago that there was inadequate training for NEDs within our industry. We researched what training courses were publicly available but found nothing that we believed was of sufficient quality and sufficient relevance to our members. We have now designed, in conjunction with Cranfield University, a course specifically for executives of private equity firms taking NED appointments.

The first course was staged earlier this year, was fully subscribed and has led us to stage a further three courses over the next nine months. We are also now looking at extending this part of our training programme to see whether further training is appropriate for e.g. chairman appointments. A copy of the course content, which is copyright protected, is attached as Appendix 5.

A further general comment is that if NEDs receive appropriate financial rewards and incentives, leading to better quality NEDs willing to spend more time with investee companies, then arguably this higher quality and commitment will reduce the number of NEDs necessary on any one board.

F. Smaller Listed Companies

In what ways is the position different for smaller listed companies?

Although a truism the comment made by one of our members, though one with considerable experience, is that the problem of attracting, rewarding and retaining effective NEDs is even greater in smaller companies. This is a particular difficulty in that these smaller companies are often in greater need of closer monitoring or guidance on strategy.

