

30 August 2002

Review of the role and effectiveness of non-executive directors ('NEDs')

The Investment Trust Division within Friends Ivory & Sime ('FIS') welcomes the opportunity to respond to the above consultation paper.

By way of background, Friends Ivory & Sime is a global investment management business with £31.2 billion of assets under management as at 30 June 2002. The Company is responsible for the management and administration of 16 public listed investment companies, comprising 10 investment trusts ('ITs') and 6 venture capital trusts ('VCTs'). The total market capitalisation of these companies, as at 31 July 2002, was £1,058.7 million and the largest of the investment trusts is a constituent of the FTSE 250 Index. A full list of the companies is included at the end of this letter. We deal with 68 NEDs in total, some of whom sit on more than one board.

This response is based on our extensive experience of providing investment management and company secretarial services to these clients. We have provided comments under each of the five sections contained within the paper. Because our comments are founded on the experience of our clients, most of which are small listed companies, we have not made any additional comments under Section F: Smaller listed companies. We do not consider that different factors apply in respect of NEDs for smaller companies.

Background to ITs/VCTs

ITs/VCTs are public limited companies subject to the same legislation as any public limited company. However, they are unusual in that the executive director function is in almost all cases subcontracted to a third party investment house. Accordingly, the board of the IT/VCT is usually made up exclusively of NEDs. This is a different type of corporate governance structure to other public limited companies where the board is normally made up of both executive and non-executive directors. The fact that ITs/VCTs have a non-executive board of directors overseeing the company's affairs is considered an important safeguard for shareholders and sets ITs/VCTs at an advantage over other forms of collective investment schemes.

ITs/VCTs represent a relatively significant number of public listed companies overall and have a somewhat different corporate governance structure. We would therefore recommend that special consideration and account is given to ITs/VCTs where the board comprises wholly NEDs. In particular:

- Definition of independence
- Guidelines for role of NED
- Balance of board skills required
- Relevance of senior independent director
- Relevance of committees of the boards
- Guidelines for methods of remuneration
- Guidelines for training of NEDs

The Association of Investment Trust Companies ('AITC') is the trade body representing its investment trust members and it has produced best practice guidance for its members in respect of the directors of investment trusts. This guidance is specifically tailored to the requirements and structures of investment trusts. This is an example of an approach based on best practice rather than regulation or legislation. It is encouraging to note that the Government's (and your own) preferred starting point is best practice. The AITC also maintains a database of potential NEDs that can be used by its members if they wish when selecting new investment trust directors. However, filling vacancies for NEDs is not easy and finding suitable candidates can be difficult.

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

As is the case with most ITs/VCTs, all of the boards of our client trusts are made up exclusively of NEDs. The executive function is performed by FIS, in its capacity as investment manager and company secretary.

We believe that the role of the NED is to review the performance of the executive function and to add additional value to the development of the IT/VCT through their own experience. For an IT/VCT, we would define a NED as a director not involved with the day to day executive function of the company. It would be possible for a NED to be an employee of the investment management company. However, this would only be possible if he was not able to influence the company's day to day affairs in this capacity.

It is up to each board who it appoints as a new NED, but we would always encourage a board to have a majority of independent directors, as set out in the Combined Code. We would define an independent NED as one who was free of any business or other relationship which could materially interfere with the exercise of his independent judgement, including in particular, one who had not been an employee of the investment management company, not been recently employed by a professional adviser to the IT/VCT, and was not on the boards of a large number of ITs/VCTs managed by the same investment manager.

We believe that, in order to carry out the role of NED effectively, and in particular the role of non-executive chairman, a certain time commitment is required. We therefore believe that there is a finite number of non-executive appointments that an individual can take on. However, we do not believe that it is possible to quantify this number but that it needs to be considered on a case by case basis before a company appoints a new NED. Being too restrictive would limit the pool of potential candidates which is already limited. We suggest that a director's "other directorships" should be disclosed in the annual report, covering present public listed company directorships. When a director is first elected to a board at the meeting following their appointment reasons for the appointment should be disclosed.

In the case of ITs/VCTs where all of the directors are non-executive, we do not believe it is appropriate for a senior independent director to be appointed, and most of our client boards have taken this view. In such situations any concerns by directors would be relayed directly to the non-executive chairman. Furthermore, we believe that consideration should be given to exempting ITs/VCTs, whose boards are make up exclusively of NED and where the chairman is non-executive and independent, from this requirement of the Combined Code. (Note: ITs and VCTs already have exemptions from certain requirements of the Combined Code, as detailed in sections 21.20(i) and 26.9(d) of the Listing Rules.)

We have no comments to make on the proposed statutory statement of directors' duties other than we support a statutory statement and especially one which makes it clear that responsibilities are the same for all directors.

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?

We believe that a board of an IT/VCT should, as a whole, possess a wide range of knowledge, skills, and experience. It is likely that each NED will possess different skills and it is important that these compliment skills possessed by other directors. For this reason we would support the selection of candidates from a broader universe than has typically been the case in the past, which will assist with the current perceived shortage of suitable candidates. The overall knowledge, skills and experience of a board should be sufficient to enable it to make reasonable enquiries of the executive function and external advisers. The particular skills required by directors may vary from company to company, but for an IT/VCT we would expect a board as a whole to possess, as a minimum, investment management experience, an understanding of investor expectations and general business experience. In addition a high level of integrity is essential.

We believe that additional skills are likely to be required by NEDs of ITs/VCTs over the next 10 years, requiring them to deal with matters such as marketing, the introduction of international accounting standards, changes to existing company legislation and increased regulation of public listed companies. For this reason, boards may need to give more careful consideration to the selection of candidates for non-executive positions, and make more use of external recruitment consultants as well as board contacts. (But see also comments on training in Section E.)

In addition, sufficient time should be allowed to recruit new NEDs so that a position is not, if possible, left vacant. A board should always give consideration to succession planning, and allow for an overlapping period when an incoming director can spend time learning how the company operates.

We believe that current levels of remuneration for IT/VCT NEDs, which have generally been rising, are sufficient to attract appropriate individuals and reflect the time committed. That is not to say, however, that there is an over supply of directors. In general, our client boards review levels of remuneration on an annual basis to ensure that these are in line with other similar companies and the market generally and reflect any additional responsibilities and time required of them.

We believe that it is appropriate for NEDs to be encouraged to receive some or all of their remuneration in the form of shares in the company, so long as the size of their shareholding does not become so significant that it prejudices their independence. The interests of shareholders and NEDs are more aligned if NEDs hold shares in the Company.

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

We believe that the Combined Code is working well in practice. However, compliance with the Code should not become a “box-ticking” exercise. As with compliance with the Turnbull guidance on internal controls, we believe compliance with the Combined Code should be integrated with the functioning of a company which we refer to as the development of a governance culture.

Because our client boards are made up exclusively of NEDs, the majority of committees of the boards comprise all of the directors of the company. We believe that this structure works well in practice, although it may be appropriate for a director other than the chairman to chair a committee if he possesses particular skills in relation to that committee’s remit or where the chairman has an actual or potential conflict of interest.

We believe that each IT/VCT board should decide how many directors are appointed and this should depend upon the size and nature of the particular company. However, we believe that the minimum number of NEDs for an IT/VCT should be 4, and the maximum number should be 8.

In our experience, boards of ITs/VCTs are able to successfully challenge executive decisions and help to expose problems. This ability is important in the selection of NEDs.

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

As investment managers of our client trusts, we meet with large shareholders (generally institutional shareholders, discretionary fund managers, and private client stockbrokers) on a regular basis and report to the boards on those meetings. Likewise, each of the company's brokers will tend to have a relationship with the large shareholders and the boards will also receive feedback through this channel. In practice, the boards do not tend to have a direct relationship with shareholders. However, the Boards are always willing to meet with shareholders if shareholders wish and there might be a case for NEDs to proactively seek to meet shareholders to have a direct understanding of their concerns. The AGM provides an opportunity for shareholders to question NEDs.

For ITs/VCTs we believe that NEDs should establish a good ongoing relationship with the executive function. Whilst not compromising their independence, this will assist them in developing a good understanding of how the company operates and therefore in performing their role effectively.

We believe that the executive function of an IT/VCT should be responsible for the day to day contact with key advisers to the company. However, any NEDs, and in particular the chairman, should be able to make direct contact with these advisers, and advisers would be expected to report directly to the Boards where required (for example at board meetings).

The company secretary can and should support effective performance of NEDs by ensuring the inclusion of high quality management information in the board papers, that board procedures are followed at meetings, and that regular communication is maintained with the directors when required. There is also an essential trust based relationship between the company secretary and NEDs that underlies his position.

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

We believe that, in addition to a regular dialogue with the executive function, board papers provided to IT/VCT NEDs should be sufficient to enable them to perform their duties effectively. It may also be necessary for them to be provided with additional information from time to time so that they are kept up to date with particular/specific matters. NEDs should have access to external advice when they consider it necessary.

We believe that, induction courses should be run for new NEDs, so that clear guidance is given on what is expected of them. Additional training may be required for the purpose of developing new skills or refreshing existing skills, and this matter should be kept under constant review. We believe that the DTI should consider facilitating training courses and provide guidance on training of NEDs. Board evaluation should be considered to assess the effectiveness of the board as a whole and each individual's contribution. It should also cover assessment of skills needed but not adequately covered by the existing board. This would assist the nomination committee in the consideration of new candidates.

G. What can we learn from international experience?

We have experience of the operations of an overseas company that operates a two-tier board structure; a management board that is entrusted with the management of the company, and a supervisory board that is responsible for supervising the management board and the general affairs of the company. Our experience does not suggest that this structure works any better than the UK one-tier board structure. It does require that the powers, responsibilities and liabilities as between each board are clearly set out. We do not consider an extra tier of board representation would enhance the corporate governance structure within the UK. One board provides unity of purpose and responsibility.

Finally, in light of recent experiences in the US, including the events surrounding Enron and World Com, it is more important than ever that boards of public listed companies operate effectively and therefore measures are taken to ensure, as far as possible, that an appropriate environment exists for this to happen.