

Response from Friends Ivory Sime

We are writing in response to your consultation document of the 7th June 2002. We note that you comment in the introduction on “establishing a clearer picture of the way boards operate today, and the contribution of non-executive directors.” We believe that the UK model of a unitary board has significant strengths in the proper governance of corporations, and when operating well is superior to all the other models that we have observed. We believe that it is vital to have an effective board as a whole, and that the role of non-executive directors should be considered as a significant part acting towards board effectiveness. All our comments are based on this principle.

There are themes that we shall return to in answer to specific questions. By way of general introduction there are various observations that we would like to make. We believe that the goals and overall responsibilities of all company directors are identical. Every director needs to contribute according to their abilities and specific responsibilities; and the whole board should work as an effective team. To that end an effective and transparent means of board evaluation should be in place. This should address the effectiveness of the board as a whole, the contributions made by each member and areas that the board does not adequately cover. There is a case for this evaluation process to be under the supervision of, and a responsibility of the nomination committee.

Transparency is an important tool in effective governance, and as such we would recommend that the terms of reference of all board committees be published in the Annual Report and Accounts {ARA}. Each committee should also report in the ARA on the discharge of their duties and any significant results of their work. We see such enhanced reporting as a major step to improving the effectiveness of non-executive directors and enhancing governance.

This additional reporting would provide the audit committee with the place to comment on how they reassure themselves as to auditor independence, especially where the company’s auditors provide significant consulting services. It could also allow for the nomination committee to provide an insight into the method used in seeking suitable board candidates and senior company executive appointments.

The roles of all directors, including non-executives should be integrated in general board practice. We would recommend that non-executives should meet formally, without the executive directors, on a regular basis, preferably on the day before any board meeting. Amongst other issues, they should oversee the process and content of the executive communication with institutional investors. This would probably mean that on an occasional and rotating basis one of the non-executives would need to attend both institutional and

analysts meetings. This non-executive grouping would also be the best placed body to supervise the functioning of the company's whistleblower policy.

We support the comments submitted by bodies of which we are members, such as the ABI, IMA, IoD and NAPF and we have also made a submission specifically on behalf of the investment trusts that we manage and for which we act as company secretary.

SPECIFIC COMMENTS

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

Q1 What is the role of the board? What is the role of the Chairman and how does it relate to the non-executive directors?

The board's role is to lead and control the company setting strategy in line with suitably long-term objectives. The long term good of the company is in turn beneficial for all stakeholders including our own particular interest, that of shareholders. Short-term expediency should only be followed when it is necessary to achieve the longer-term goals. The board should review company performance and set strategy. They should, through board committees have oversight of certain key issues, audit, remuneration and nomination. For many companies there are other such committees that would prove of value to cover, amongst others, corporate risk and social, environmental and ethical issues.

The chairman's role is to set the board agenda, in conjunction with the company secretary and the CEO. He should then chair the board meetings so as to ensure effective operation of the board with all views being considered and decisions reached that the executive management can understand and implement. For larger companies the chairman should be neither executive nor non-executive. He should not chair any of the board committees and there is a case for saying that he should be a member of none of the committees, but attend all of them as an observer in order to ensure that he has the fullest understanding of the company he chairs. The chairman will, on occasion have a relationship with the company's major shareholders.

Q2 What should be the key roles of non-executive directors on the board and what should be the balance between the different components? Within a board, should all non-executive directors be expected to fulfil each of the different roles?

The primary roles of non-executive directors relate to the effective management of the company. In addition they should ensure good governance by the Board. They should ensure

that conflicts of interest do not impair this latter role. Non-executive directors can also enhance discussion of company matters by bringing a fresh perspective to the board. They can also be a valuable source of external expertise to the company. Not all non-executive directors need to fulfil each of these different roles. What is important is that the body of non-executive directors do so and that the required mix of skills is accessible.

Non-executive directors should have time to visit the operations of the company, unaccompanied by senior executive management, in order to enhance their understanding of the operations and to provide a conduit for information to flow to the board. Non-executives should form half or at the very least one third of the board and a majority of the non-executives should be independent. At the same time it is important that there are a sufficient number of executive directors on the board so that the board is the executive organ of the company, not solely a supervisory body.

Q3 *How does this compare to the present position?*

This varies from company to company. Where problems have arisen, weaknesses of non-executive directors have often been a contributory cause. Currently, it is difficult for outsiders to assess properly the contribution of non-executive directors to a company, and most evidence is purely anecdotal.

Q4 *How independent do non-executive directors need to be for the different roles?*

Independence has importance in bringing fresh thinking to the board's considerations. It also provides those outside the company with the reassurance that someone of probity, and not dependent upon the company, but with real access to company matters has endorsed the published statements and to the general trustworthiness of the enterprise. Different qualities of independence are appropriate for these different roles which non-executive directors are expected to play. This means that undue focus on pre-determined definitions of independence is rarely helpful. Different criteria may be appropriate in judging the appropriateness of particular non-executive directors sitting on the Remuneration and the Audit Committees. The prime consideration for committee chairmen should be that they are effective chairmen and ensure that their committee has all the expertise that it might need to fulfil its role.

Directors who represent specific shareholdings or other interests need to remember that their prime responsibility as a director is to the company, not their specific interest. As such they need to act with special care, and if they cannot act as part of the unitary board a replacement should be sought.

Q5 *What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a role in protecting the interests of the*

company? What can be done to help non-executive directors to be effective in relation to these conflicts?

The main potential conflicts of interest will tend to relate to matters which, broadly, are within the scope of the Remuneration and the Audit Committees. Non-executive directors need to recognise that potential conflicts exist and, where required, they need to be robust in ensuring these are managed in a manner which best serves the interest of the company. On occasions, it may be appropriate for them to discuss problems with major shareholders. This will be the exception rather than the norm but it is essential that non-executive directors recognise their obligation to do so on such occasions and that they have the ability to initiate such contacts.

Q6 *What time commitment is needed for the role of Chairman and for non-executive posts that one person can sensibly take on director roles, and how far does this vary between different companies? Are there any implications for the number of non-executives.*

In taking on a non-executive director or chairman role it is important to be able to commit sufficient time to carry out the job even when extraordinary demands are made in exceptional circumstances. The time requirement for the chairman will be significantly greater than for non-executive directors, and the time requirement for the chairs and other members of the board committees greater than for those without these extra roles. The time required will vary from company to company and this may be by a significant amount. This does mean that there can be only a limited number of such roles any individual can effectively undertake, but it is not possible to set a specific number, since the demands of the several roles vary, rather the constraints on time in exceptional circumstances should be the limiting factor. That said it is unlikely that the chair of a substantial and complex public company would have sufficient time for other significant appointments. One way of spreading the burden is for there to be a larger number of non-executive directors, but this should not be taken to excess, since overlarge boards are cumbersome, ineffective and expensive.

Q7 *Should there be a special role for a "senior independent" non-executive director?*

Yes, except for investment trusts.

Q8 *Do you have comments on the proposed statutory statement of directors' duties, which does not seek to distinguish between the legal duties of executive and non-executive directors?*

We agree that there should be no distinction.

B: Attracting and appointing non-executives - What knowledge, skills and attributes

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

Q9 *What are the key skills, knowledge and experience which are needed by non-executive directors to perform the role effectively, and how is this likely to change over the next, say, 10 years? Are some skills essential and, if so, what are they?*

In general personal qualities are more important than specific skills. That said we believe that one third of the non-executives should be executive directors or very senior executives currently employed within other quoted companies. In addition there should be the skills needed to bring informed comment on the company's strategy and to the various board committees. As mentioned earlier review of the board's performance should specifically seek to highlight such gaps and the nominations committee seek to fill them. Later we comment on the need for adequate training.

Q10 *What personal qualities and attributes are needed?*

Clarity of thinking, a willingness to embrace the role, a questioning attitude, openness, courage, tact and trustworthiness. They must also work effectively within the team that is the board.

Q11 *What sort of mix of experience and attributes is desirable on a Board? Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.*

This is a question where the real answer has to be it all depends. An example that covers many aspects of the value of an outstanding non-executive occurred at a very small company, Intercare. The Chair/CEO had built up the company. Under shareholder pressure he found an excellent NE/chair. There were problems with the company and it was apparent that a new CEO was needed. The new chair explained to the two existing non-independent non-executives what their responsibilities were, and they behaved accordingly. In the event the CEO and his FD bought out one division and left, retaining a significant shareholding. This left the new chair with a lopsided company, questionable executive management, a pile of cash and a number of dissatisfied shareholders. He gained shareholders short term confidence, stabilised the company under his control and then found a new CEO. A strategy for the company was developed. Having done all this he found his successor as chair. This individual had run a very large company and was able to bring considerable experience to Intercare, but it seems a classic illustration of what can be done.

Q12 *How easy is it to recruit non-executive directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?*

There seem to be differing views. It should not be too difficult, but perhaps the pool often looked to is too narrow. The encouragement of senior below board level executives to take up a non-executive role should benefit both companies for whom the individual works. Public advertisement should have a place. Greater reporting of the contribution made by non-executives should encourage the finding of non-executives who contribute materially to the company rather than being a well-known name with a reputation to lose. There is a need for everyone (i.e. directors, shareholders employees and the public at large) to have an expanded understanding of what non-executive directors can and cannot do and the real contribution that they can and should make.

Q13 *What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?*

Much of this has been touched on in the answer to question 12. Good quality, and continuing training of non-executive directors should make it easier by adding to the pool of potentially good non-executive directors. Better reporting of the activities of non-executive directors should have the benefit referred to above. Proper viewing of the diverse range of people able to discharge the duties effectively must increase the pool. International representation would also have this effect. There are some potential problems with travel, cultural and language. These can be both merits and demerits. It may be a good way to demonstrate the UK style of unitary board management and spread its effective operation around the world. As ever, it has to be the right individual with adequate time to devote to the job.

Q14 *Are the rewards for non-executive directors appropriate, both in terms of levels of pay and the form that remuneration takes - e.g. cash/shares/share options? Are current pay levels a significant factor in whether good non-executive directors can be attracted?*

We believe rewards for non-executive directors need to be appropriate to the role and responsibility, the potential time commitment and potential liabilities. Good non-executive directors are a valuable resource to companies, which should not be afraid to pay the appropriate rate. This payment may take the form of either cash or shares in the company but we are strongly opposed to the concept of awarding share options to non-executive directors as it is essential that non-executive directors take a balanced view of all decisions impacting on the company's development. It is also important that independence of non-executive directors is not compromised through their participation in incentive schemes. Where directors return their fees to their full time employer, there is a case for the full time employer's remuneration being reduced pro-rata and the NED retain their earnings, especially where a proportion is paid in shares. We feel that the

current levels are somewhat low for effective non-executive directors although far too high for those individuals who merely lend their name and otherwise contribute little.

Q15 *Do you have comments on the issue of risks or insurance provision for non-executive directors?*

In an environment which has become increasingly litigious, adequate insurance is essential if existing non-executive directors are to be retained and future non-executive directors recruited. Unfortunately, adequate and affordable insurance is becoming increasingly difficult to obtain. It may therefore be necessary for the Government to take on a role here.

C: Structures and accountability - Do existing structures and procedures facilitate effective performance by non-executive directors?

Q16 *How is the Combined Code working in practice? In particular, how are the provisions on the balance between executive and non-executive directors and the role of independent non-executive directors working? Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?*

Independence is an approach that all directors should bring to their role as company director, be they executive or not. However the leavening effect of fresh, but informed thinking brought to the board is one of particular contributions of non-executive directors. This is one of the virtues of the regular movement within the non-executive director element of the board. That said, we believe the Combined Code, and the requirements for companies to comply or disclose reasons for non-compliance, work reasonably well although we favour much enhanced reporting believing that this will produce significant extra benefits. We see no compelling reason to require a change in the balance between executives and non-executive directors, or between independent and non-independent directors. There will be difficulties in devising a clearer definition for Combined Code purposes of the status of independence for non-executive directors appropriate in all circumstances. The ABI, in common with the NAPF, has established a working definition of independence that can be used for comparative assessment between companies.

Q17 *Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors? Are board meeting procedures working effectively? Do you have comments on board size?*

The currently recommended structures for board committees do, we believe, facilitate good governance and effective contributions by non-executive directors. However it is difficult for an outsider to assess the effectiveness of the contribution of non-executive directors, as little is known about board and committee meetings. We therefore recommend much more disclosure

of the operation of the various board committees. This should both enhance understanding and improve practice. Board size varies according to a company's needs, but it is self evident that an overly large board may become unwieldy and difficult to run efficiently and effectively. Conversely, too small a board may find its duties too onerous to complete, thus placing the directors in a position of unnecessary risk of failing to fulfil their individual duties.

Q18 *Do you have comments on the composition and duties of Audit Committees? How effectively are Audit Committees working in practice? Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?*

We believe that audit committees usually perform a worthwhile function. It is important that they have a visibly independent appearance. The members should exhibit the qualities referred to above in the relevant question. At least one member should have a reasonably deep understanding of accounting, but there is a strong case for intelligent questioning by someone unfamiliar with the more detailed aspects of current practice. The chair should be chosen for their qualities as chair, and he probably should not be the expert. Once again, transparency and quality reporting would help. How does the committee satisfy itself as to the true independence of auditors, especially when in receipt of significant fees for consultancy work? How are decisions as to aspects of accounting treatment that may affect the report made?

Q19 *Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?*

Transparency in the operation of the nominations committee would be a major step forward. It sometimes that the nomination committee does little work. Suggestions made earlier would substantially enhance its role. Remuneration reporting is improving; committees are sometimes not trusted by executive management and a visible distance as well as good working together would improve the situation. Once again reporting of the practice of operation would be welcome.

Q20 *What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?*

Few companies provide information on this. We are aware of positive response to such evaluations. A number of organisations now offer board evaluation processes, and we support their use by companies on a regular basis.

Q21 *Could more be done to review performance? Should more information on board performance be reported to shareholders? Should companies provide more information on the performance of non-executive directors?*

Board evaluation with some external involvement is important but this does not extend to a requirement for public disclosure of individual performance. Good processes will protect the company and its board where there are difficulties. We suggest that the nomination committee should be responsible for undertaking evaluation and making a suitable report to shareholders.

Q22 *Are non-executive directors able successfully to challenge executive decisions or expose serious problems? Should it be made easier for them to do so and, if so, how?*

We are aware of a number of situations where this has arisen. They must be able to do so but they are not an opposition to the Board. Where appropriate they must be prepared to discuss matters with shareholders. This contact can materially strengthen their ability to mount a successful challenge and is one of the reasons behind our recommendation that there should be a programme that promotes regular contact between non-executive directors and major shareholders.

D: Relationships with shareholders and others - Do existing relationships with shareholders or others need to be strengthened?

Q23 *How well do relationships between non-executive directors and shareholders and stakeholders work, and could they be improved? For example, we would be interested to hear views on what the relationship might be between non-executive directors and institutional shareholders. How could this relationship be strengthened?*

We have stated frequently in earlier answers that we consider this to be important, and have made various suggestions to achieve this.

Q24 *To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more that they could do, by promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows, or otherwise?*

Some chairmen do this well. A general description of best practice might help. Essentials include setting and following the right agenda and the distribution of full board papers in good time for all directors to read them and pursue some enquiries, if needed. We commend a meeting of the non-executive directors on the day prior to board meetings to have discussions where mutual concerns may be voiced. This same grouping should also review the executive's communication with shareholders and on internal matter, they should oversee the company's whistleblower policy.

Q25 *What should be the relationship between non-executive directors and executive directors, and with senior management? What should their relationship be with the Chairman and the Chief Executive? What should their relationship be with key advisors to the company?*

It is appropriate that non-executive directors have engagement with the executive directors and other senior management beyond merely their discussions and deliberations within the structure of board meetings. They should listen and act as mentors. The chairman mentors the CEO; the non-executive directors should mentor the chairman and, to a lesser extent, the other executives; the audit committee chairman should mentor the finance director; and the remuneration committee chairman should mentor the CEO on pay and influence the HR side generally. The Remuneration Committee should also have contact with the remuneration advisers, if any, employed by the company, though in many cases the Remuneration Committee itself should appoint independent advisers.

Q26 *How can Company Secretaries support effective performance by non-executive directors?*

The importance of the role of the Company Secretary in the governance framework for companies should not be underestimated. It is vital that the relationship between that individual and the non-executive directors is uncompromised by the potential conflicts for executive directors. The Company Secretary is responsible to the board of the company and not, primarily, to the company's management. The company secretary should be appointed and employed by the board specifically rather than by the company. In our experience, company secretaries provide an effective conduit for shareholders to address the whole board, or for us to contact non-executive directors.

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

Q27 *How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?*

Non-executive directors should have unfettered access to all information held by the company. In practice, they must of necessity rely on the chief executive and other officers of the company to provide them with relevant and timely information. For their part, non-executive directors will be in a better position to know what to ask for if they have had the time and opportunity to talk informally to senior and other management

and to prepare for meetings. In our experience it is unusual but not unknown for non-executive directors to have full information.

Q28 *What training and developments opportunities are available? Could they be improved and, if so, how?*

We agree with the NAPF comment which for completeness is copied here.

The NAPF is aware of the 'Chartered Director' initiative, recently introduced by the Institute of Directors, which aims to raise the bar in terms of non-executive directors' levels of knowledge. The NAPF supports the principle of such initiatives although it would not see such a qualification as being a pre-requisite to board membership, particularly given the expected slow rate of growth in the numbers becoming qualified.

Q29 *Can induction for non-executive directors be improved?*

Yes. It is all too often non-existent.

Q30 *Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?*

Very rarely. We support initial and ongoing training; board evaluation and the public reporting of much of the work carried out by non-executive directors. All of this would significantly improve the situation.

F: Smaller listed companies - In what ways is the position different for smaller listed companies?

Q31 *To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?*

Non-executive directors are particularly important for smaller companies. Their role may well be stronger in testing corporate strategy and in mentoring than in larger companies. We believe that in suitable circumstances it is possible for the chairman of a smaller company to be regarded as independent so that he can help as a member of board committees.

G: International context - What can we learn from international experience?

Q32 *What lessons can be learnt from international experience, either in terms of structures or behaviours?*

We believe that it is always valuable to be aware of other's practice, to be able to modify and improve practice and reporting. For example, we applaud the briefings provided to companies by the Hong Kong Stock Exchange on the role of non-executive directors.

Q33 *Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?*

Improved trust and co-operation with all stakeholders is difficult to achieve but should contribute to company performance.

Q34 *Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?*

The two tier board structure, for example that employed in Germany, and in effect the system practised by most major corporations in the USA has some virtues, but often exhibits weaknesses by the board being too distant from the company and shareholders are at an even greater remove. We consider that UK board structure and models of corporate governance work as well as any internationally, if not better. Optimal structures will vary from country to country reflecting different cultural aspects as well as different legal arrangements. However, principles should be universally applicable and it is important to be aware of progress in other jurisdictions, and to incorporate approaches that might further enhance UK practice.

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