

12th August 2002

Mr. Derek Higgs
Non-Executive Directors Review
Room 2142
1 Victoria Street
London SW1H 0ET

Dear Derek

Review of the role and effectiveness of non executive directors

I have given some reactions to each of the questions which you have suggested. These responses mainly support the status quo. More helpful perhaps is to just list any strong opinions or new thoughts.

- (1) I am certain we should preserve the unitary board, and avoid stressing it further by trying to define responsibilities more closely.
 - (2) The Audit Committee should be responsible for recommending the appointment or reappointment of the auditors to the Board.
 - (3) The Audit Committee should co-opt expertise from outside if it does not feel qualified to monitor the auditors of the finance function. (as is done in the University sector).
 - (4) The Audit committee chairman should review formally whether the non executive directors and particularly the Chairman are independent and the auditors should review
 - (a) his independence and
 - (b) the process of review and any arguments used by him.
 - (5) There should be some pump priming financial support of new organisations running development programmes for directors, non-executive directors and Chairmen.
 - (6) The review of directors' and Board effectiveness should be reported on annually.
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- (7) Line Management not just Internal Audit should have access to the Audit Committee Chairman and vice versa, possibly via the Company Secretary, in addition to any meetings/exposure arranged at or for the Board. I don't know how to facilitate this point but it is important.

I wish you well in your mission and I hope that your report in the main supports the status quo. We just need to make it work better and I think directors are more "scared" already. If we tighten the screws too far no one will be prepared to chair the Audit Committee.

Yours sincerely



Trevor Harrison

Notes on the Questions on the Derek Higgs Consultation Paper

A Role

Board

- 1.. Set direction for the Management Team (i.e. strategy(ies))
- 2.. Appoint Management Team (and change it)
3. Agree budgets and Review Performance of Management Team
4. Agree major resources into business and major transactions
5. Carry out other reserved powers
e.g. Remuneration of Directors
Nomination of Directors
Audit matters via Audit Committee

Chairman

1. Lead and manage Board and Board Processes
2. Review performance of Directors
3. Lead NED's in review of performance of CEO/Executive Team and if necessary making changes
4. Involve NED's
5. Ensure appropriate information/access available to Board
(Access to management is particularly important)

NED's and Chairmen

- 1 First responsibility is to support Chairman and CEO, but to have a clear means of checking whether this support is justified
- 2 With or without Executive Directors should consider effectiveness of Chairman

2. Key roles of non-executive directors

1. Any or all should be involved in all component roles (unitary concept)
2. The role of the NED's is the same as that of the Board as a whole (A Board 1-5)
3. Within that, the NED's probably bring experience which is either wider or sometimes more specialised than is there in the Executive Team, or they are capable of bringing a second opinion because of having strong experience in the same area as the Executive team.
4. In particular additionally the NED's should look to protect stakeholders interests, usually shareholders but sometimes lenders, creditors or employees. Executive Directors have the same responsibility but can have a personal conflict.
5. NED's should be chosen to give a blend of skills and experience – for example an experienced accountant would be on the audit committee but not necessarily the Chairman of the committee.

3. How does this compare to the present position?

This is broadly the present position. We need to preserve the unitary board and allow the NED's to be closer to management. Two tier boards reduce communication and increase remoteness.

4. They do need to be independent for all roles.

5. Conflicts of interest

1. Reward packages geared to shortterm stock market performance.
2. Other business interests of executive directors
3. Require disclosure of all other interests by all directors and their income from these interests.

6. Time commitment

Chairman - usually one day a week, Non executive Directors – 2 days a month – a bit less in single business companies. How many NED posts. One Chairmanship and 3 NED's or 5 or 6 NED's would be sensible limits

7. Senior independent NED

Formalising this is not really necessary. In a crisis he would emerge. The institutions can talk to an NED if they wish.

8. Do not distinguish between the legal duties of execs and NED's. Doing so will start to divide the unitary Board.

B. Attracting and appointing NED's

9. Key skills

1. Must bring some skill and experience to the Board which is additive to those of other members.
2. General business experience is the main quality. Some businesses will benefit from having accountants, lawyers or actuaries as NED's – others from having engineers, marketeers, or international experts. The test is have we got most key areas covered between Execs and NED's.

10. Personal qualities and attributes

Independence, Free thinking, Tough, Courageous, Fair, Listener, Communicator.

11. See 9.2

Large high profile public companies could do to have experienced political or media inputs to guard against strategic or presentational exposure. E.g. George Thomson (ITV) and others stopped ICI from allowing NIREX to buy the Billingham Anhydride mine as a nuclear waste store on the grounds that local communities would object on 'Nimby' grounds and certainly to the waste transports coming and going.

12. Should be easy because the pool of qualified retired candidates in theory is very large. Many retired executives do not want the risk for modest reward. Executive directors in full time employ can only take on say one NED appointment so there the pool is rather smaller.

Recruitment by the professional search route is a problem because the fee available is small compared with that for full time directors. There is probably room for further search firms specialising in non-executive director appointments but the economics may be difficult.

13. The pool is probably large enough although probably there is more scope for practising lawyers to be non-executive directors. International representation is valuable on any company trading or manufacturing internationally.

14. Yes, when things are going smoothly. No, when the going gets tough. In public companies cash is best. In smaller private companies an equity stake may top up a low cash payment.

I doubt whether pay levels are a significant factor in attracting NED's.

15. Hitherto the risks were low. I don't believe in insurance. The proper protection is professional behaviour (and contemporaneous notes). In future post Equitable Life, concerns over audit, and the Company Law Review, things could be much more difficult. The exposure looks to be increasing. This might put pressure on pay levels and on insurance premiums.

C. Structures and accountability

16. Combined Code is working well. Independence is not as sharply defined as it might be but also auditors and other non-executive directors need to be careful in reporting on whether directors are independent. I have seen this fudged (and didn't stop it myself). The institutions have produced some good definitions but it should include:

Not being dependent financially on the fee

Not being a personal friend of the Chairman, the Chief Executive or the Finance Director

Not being a former executive or executive director.

(Unless the lack of independence is disclosed and justified.)

17. Structures do facilitate governance. Board procedures depend on the Chairman and the CEO. Chairman's role is crucial in having sound governance. Perhaps his accountability should be further stressed. Boards should be as small as possible capable with the experience needed to guide the business(es), 5 executive 4 non-executive should be maximum for most companies and 2 executives and 3 non-executives works well in small companies.
18. Audit Committees can work well if well chaired. Some committees may need a specialist member who can second guess the auditors. This could be a retired practising accountant who joins the audit committee without being a Board member. (This practice already exists in the University sector).
19. Nomination committees are often likely to be a bit of a game because in practice the Chairman and Chief Executive have such a strong say in appointments other than their own. Remuneration Committees are dogged by the bad input of Greenbury which by suggesting market alignment just triggered an upward only gravy train. Many Executive Directors are overpaid relative to their value but are pulled along in pay by others.

20. This is a weak area. In my experience very little except in areas where Boards are somewhat regulated e.g. by HEFCE in the University sector.
21. The Directors report should say that performance of the Board and the individual directors has been formally reviewed. The process should be led by the Company Secretary with the Chairman and reviewed by the auditors.
22. Yes, NED's can successfully challenge, but it is a question of power and personality. Things go wrong when people like Hitler, Saddam or Milosovic are running things. There are many "mini" dictators around. They are hard to stop. I don't think you can make that task easier.

D. Relationships with shareholders and others

23. Normally there should be no regular channel of communication between NED's and shareholders. This should be done by CEO, FD and Chairman. If the company is performing badly shareholders should take up their obvious right to talk to any member of the Board. A Board refusing this is likely to find the shareholders queuing up for more.
24. Some Chairman do all this well, others not. It's down to the individuals. There is scope for a lot more training and shared experience for Chairmen and NXD's.
25. NXD's should seek to interact with senior management. This can be a bit like undercover work because you are looking for clues (think of Enron) but it is probably dangerous not to do it. In the best companies this should be a totally open process with difficult issues discussed freely at the Board and outside. (Mostly there is a "control freak" in the way).

The relationship with the CEO and Chairman should be respectful and professional and supportive until the time comes to disagree (or "disappoint"!). Post Enron the NXD's need to take more interest in the selection and behaviour of advisers.
26. Company Secretary is a very valuable channel for an NXD. Probably much underused.
27. Mostly information flows are good. There isn't time or money to have separate flows for management and Board. The NXD's tend to see the management information. This is possibly not the case in very large companies however.
28. There are development opportunities – They need funding support.
29. Yes. Individual NXD's only need to ask (Company Secretary will arrange).
30. Not usually.

F: Smaller listed companies

Most of my responses above are based on experience in smaller listed companies. I doubt whether different provision is necessary.

G. International context

32 That the unitary UK model is probably the best, albeit difficult to manage.

33 I don't know of any.

34 I don't believe so.