

Response to the Non-executive Directors Review

Summary

Hermes has for several years argued that the role of outside directors needs to be seen more as a professional one. Sadly, too many outside directors have seemed implicitly to agree with Tiny Rowland's estimate of them as baubles on a Christmas tree. Good outside directors spend enough time on their company to demonstrate their value, which is well beyond mere window-dressing. If there were more such quality outside directors, the cynicism which often pervades executives' perceptions of them would rapidly disappear.

Several issues are clarified immediately the outside director role is seen as a professional one:

- there should be a **formal appointment process** for outside directors. Personal recommendations are unlikely to locate the best candidates for such roles, whereas newspaper advertisements can be a useful tool. The process should also involve an **induction**, which will need to include meetings with shareholders.
- the outside director needs to be able to spend enough **time** on each directorship sensibly to contribute to board discussion and the future of the company. This implies that there are likely to be limits on the number of roles each can hold
- we should be prepared to **pay more** money for the services of quality professional outside directors whose time is precious. Paying this increase in shares (though not in options) which must be retained would effect a clearer alignment of interests between outside directors and other shareholders and will drive performance
- the roles of outside directors on board **subcommittees should be formalised**, so that there are clear functions to be carried out which are subsequently approved by the board as a whole. The subcommittees should themselves hire the independent advisers they need effectively to perform their duties
- the professional outside director will spend more time making **contact with shareholders and other stakeholders** in his or her company, including bond investors, staff, suppliers, regulators and customers, as well as regular visits to company sites
- professional outside directors will not be shy of seeking **training**. This would be both at induction and throughout the appointment, and might include detailed insight into the company's industry as well as discussion of the role of the outside director itself
- professional outside directors, and boards as a whole, would not be shy of **performance assessment**, to enable them to continue to improve the service that they offer their company
- the need for a **professional body or institute** to support the specific requirements of independent outside directors

Each of these issues is discussed in more detail below in answers to the relevant questions.

Introduction

Hermes is one of the largest pension fund managers in the City of London and is the principal manager of the BT Pension Scheme and the Consignia Pension Plan. It has approximately £45 billion under management, of which around £20 billion is invested in UK listed companies. Hermes believes that companies with informed and involved shareholders will outperform in the long-term as oversight by shareholders encourages management to pursue strategies that achieve superior long-term shareholder returns. Consequently, Hermes has for some time taken an active interest in the performance of boards and their observance of corporate governance best practice. While shareholders must not micro-manage the companies in which they invest, they can monitor the performance of directors and hold them accountable for their stewardship of the company. Such accountability is most frequently exercised at company general meetings where shareholders have, in the extreme, the formal sanction of not re-electing under-performing directors to office.

That said, the leadership of companies is an art not a science and the board should function in such a way that the whole is greater than the sum of the parts. The collegiate, unitary board of UK companies means that the role of the outside director is less clear cut than it may be under alternative board structures. Hermes shares the view of the Cadbury Committee report in that, while outside directors certainly have a control function it "should not in any way detract from the positive contribution which they are expected to make, as equal board members, to the leadership of the company." By equal measure, much of what is discussed in the context of the roles and responsibilities of the outside director can inform those in the role of executive director. The focus should be on improving the performance of all directors, and thus of boards, as much as on the performance of outside directors in particular. Once inside the boardroom all directors should act with integrity and independence of mind and in the long-term interests of the company. For this reason it is in Hermes' view difficult to set a single standard of best practice for outside directors or for boards. As Hermes explains in its UK Statement on Corporate Governance and Voting Policy (copy enclosed) "Hermes is committed to applying its ... policies with thought, giving due consideration to the specific circumstances of individual companies, and will adopt a pragmatic approach where appropriate." For such a pragmatic approach to be effective it is incumbent on boards to explain and justify to shareholders the structures and composition chosen in light of the company's specific circumstances. In this way, UK companies should be able to have the optimal working style to achieve long-term success.

Also attached is a copy of Hermes' Guide for Shareholders and Independent Outside Directors, which aims to clarify our view of the likely nature of contacts between investors and outside directors. The aim of this document is to remove some of the discomfort we sometimes find that companies and directors feel about our requests for meetings with outside directors. Such meetings are not attempts to circumvent the usual communications channels between investors and companies, the executive team principally, and the chair. For us, non-executives are a parallel channel of communication and not one used on a regular basis, but it is important to us that this parallel channel is open at companies about which we have concerns, to enable us properly to exercise our stewardship obligations in respect of those companies.

Throughout this document, Hermes uses its preferred term 'outside director', rather than non-executive.

A: Role

What role should non-executive directors perform, and how does this compare to the present position? Possible issues for comment:

1. **What is the role of the board? What is the role of the Chairman and how does it relate to the NEDs?**

The overriding role of the board is to provide direction for and control over the management of the company. This includes guiding management on strategy development through acting as a sounding board for senior executive management, some of whom may be board directors; monitoring progress towards achieving goals already set, both financial and non-financial; advising on and, where applicable, approving major changes in the business; setting the ethos of the company through published policy documents and through the behaviour of the board as a whole and of its members individually; contributing to remedies to address shortfalls in the performance of the company; and dealing with crises and sensitive issues.

The effectiveness of a board in achieving these ambitions depends heavily on the chairman. His role is pivotal in that he is the board member with "a foot in both camps". Even the so-called non-executive chairman (whom Hermes prefers to refer to as independent chairman) necessarily has a close working relationship with the executive management team. The chairman must balance the board and the egos and interests of those represented on it. He ensures the effective functioning of the board by observing the contributions made by individual members and how they impact on the quality of board operations. It may be necessary for the chairman to coax contributions out of some directors, particularly those executive directors who may have difficulty taking a contrary view to that of a more senior executive colleague. Proactively drawing in individuals where their contribution would be beneficial not only ensures that each has had his say but also that decisions are, and are considered by members to be, collegiate. Drawing individuals in at the most appropriate moment requires the chairman to know the board members and how they operate as well as understanding the politics at play. Where the performance of an individual member is not satisfactory it should be the chairman who deals with the matter, confidentially and promptly. The processes of the board are also likely to be determined by the chairman and it is his responsibility in principle to ensure that all board members are fully briefed on developments in a timely and accurate manner, particularly between scheduled board meetings.

The chairman is also most likely to act as mentor and confidant(e) to the chief executive. As the most senior board member there may be occasions where it is necessary for the chairman to confront or oppose the chief executive and for this reason Hermes believes it important that the chairman is fully independent.

2. **What should be the key roles of NEDs on the board and what should be the balance between the different components? Within a board, should all NEDs be expected to fulfil each of the different roles?**

To contribute to the overall roles of the board discussed above, Hermes believes there are three key roles for the outside directors. As our Statement on UK Corporate Governance & Voting Policy puts it, these are contributing to the strategic direction of the company; providing expertise and experience which

might not otherwise be available on the board or to the company as a whole; and a governance function, particularly providing oversight of the executive management. To the extent that the executive management are directors, the outside directors are the eyes and ears of the shareholders on the board and should aim to ensure that the interests of shareholders are protected and promoted, particularly if these are in conflict with the interests of the executive management. All the outside directors will contribute to a lesser or greater extent in all three areas.

On strategy, the outside directors have a duty to ensure that the company does, and will continue to, earn a return over and above its cost of capital and demonstrate it has sustainable competitive advantage in the businesses it operates. Companies need to fully exploit their opportunities to grow profitably, and long-term investment is valuable, provided that there is the potential for financial returns in the future which fully compensate for the upfront costs. The strategy most likely to deliver returns to shareholders will be a focus on core competencies which enable the company to protect and enhance its competitive advantage in its chosen market. Outside directors should be able to explain what their company's core competencies are and how those are being exploited to the full; they should also be prepared to explain why their company is the 'best parent' of all the businesses it operates.

The balance between the direction and control functions will depend on the specific circumstances of the company but in general it would be likely that time is spent equally on direction (developing strategy, setting the corporate culture, building the corporate reputation) and on control (monitoring the implementation of the strategy, ensuring systems and procedures are robust, dealing with board procedural and structural matters).

It would perhaps help if the exact contribution expected of the board members were set out in a company-specific terms of reference document for the board and its subcommittees. This could of course be amended over time and would be an internal working document rather than a public one. It would provide guidance and a reference point for the board members on matters such as board procedure and accountabilities.

3. How does this compare to the present position?

It is difficult to make a general assessment of how the above compares with the present position as practice varies considerably across boards. Anecdotally, it would seem that some outside directors are not clear what is expected of them in board discussions or believe that their contributions on strategy are not given full consideration because of their 'outsider' status. The oversight role can be difficult because of the asymmetry of information between the overseers and the overseen, who tend to be the ones providing the information. Where outside directors believe themselves disadvantaged a formal terms of reference document may help set the working practices of the board and thus address the problem. However, to an extent it is a matter of attitude and unless the executive management have respect for the decisions and recommendations of the board little will be achieved. It is incumbent on the chairman and the chief executive to build constructive working relationships between the outside directors and the executive directors within the boardroom and between the board and the executive management outside it. It is also incumbent on the

outside directors to spend sufficient time on the company to ensure that they can make valuable contributions to board discussions.

4. How independent do NEDs need to be for the different roles?

All the directors should be exercising independence of judgement and integrity in fulfilling their roles. For the outside directors to have sufficient independent influence, particularly on matters where the interests of the executive management and shareholders might diverge, it is in Hermes' view necessary for at least three and a majority of the outside directors to be fully independent by Hermes' definition (as discussed in our corporate governance policy and in more detail below). It is essential for a director himself not to be the only independent voice on the board. It can be difficult enough to dissent from a common position but if it is clear that only one director will ever play devil's advocate and will as a matter of course get no support from the others then dissent is futile.

5. What are the main potential conflicts of interest which may arise within a company where NEDs can play a role in protecting the interests of the company? What can be done to help NEDs to be effective in relation to these conflicts?

There are two main areas of potential conflicts of interest where the outside directors can play a crucial role in preventing minor problems escalating into major reputational or financial crises. The first type arise where the interests of shareholders and the executive management diverge, the most common of these is in the area of executive pay. These are most effectively dealt with by properly constituted board sub-committees with the delegated authority to hire their own fully independent advisers, to seek solutions and to recommend appropriate courses of action to the full board. An additional safe-guard is to require the sub-committees to report to shareholders on their activities. There can also be conflicts of interest in strategic matters, particularly in mergers and acquisitions, where we would expect outside directors to be vigilant in ensuring that the eagerness and self-interest of the executives was not preventing proper consideration of all the implications of a proposed transaction.

The second type of conflicts of interest where outside directors can assist are ruptures within the senior executive team say when succession power struggles, problems realising strategy, or a difficult decision, such as to abandon an unprofitable project, are not dealt with effectively because of the vested interests of the executive directors. The objectivity of the independent outside directors can ensure solutions that are swift and in the long-term interests of the company and its shareholders. To be effective in this role, outside directors need to believe that they are authorised to step in to such situations and contribute to the solution. The senior independent director (whose role is discussed below) can help in situations where the chairman is involved or where canvassing the opinions of shareholders is appropriate. Again, a formal terms of reference document outlining the expected action on the part of outside directors in this situation may be useful.

6. What time commitment is needed for the role of Chairman and for NED roles, and how far does this vary between different companies? Are there any implications for the number of NE posts that one person can sensibly take on?

The time commitment required of individual directors will vary considerably depending on the type of company and the situation of the company, the individual's role on the board and his personal working style. It is for the individual to determine how many commitments, including executive and outside board positions as well as other activities such as charity work or advisory roles. It is important that directors have the capacity to dedicate more time to a board role should it be required, such as during a takeover bid or business crisis. Although Hermes does not set a limit on the number of positions an individual should hold it does seek reassurance that a director is not over-committed when he has more than five plc directorships.

7. Should there be a special role for a “senior independent” NED?

Hermes does believe that there is the need for a special role of senior independent (outside) director and its views on the specifics of the role are set out in its Corporate Governance and Voting Policy. There have been over the last decade a number of situations where a breakdown in relations between the chairman and chief executive has resulted in the resignation of one of them. Experience suggests that this very difficult time for the company can be made less so if there is a senior independent director for shareholders and the other board members to consult. Outside crisis situations, there are a number of functions associated with the running of the board for which a senior independent director can take responsibility. In many respects the role is an extension of that of a fully independent deputy chairman. Perhaps if that phrase had been used in the Combined Code there would have been less objection to the idea on the grounds that it could be divisive.

Perhaps the most significant contribution the senior independent director can make is to ensure that the views each outside director are given due consideration and provide a communication channel between outside directors and shareholders. This communication channel should be in addition to and not replace existing channels and for many companies it may have only occasional and irregular use. Equally, sometimes the chairman, especially if he is heavily involved in the operational side of the company (eg at times of crisis or during deal negotiations) may not always be the most appropriate person with whom to air concerns, either on the part of the shareholders or the outside directors. In such situations it can be helpful in preventing misunderstandings or incorrect views being formed to approach a senior, experienced outside director who clearly has a mandate to speak to interested parties when they believe they need such contact. Sometimes those conversations may need to be kept confidential, at other the times the senior independent director may be expected to relay the information to the chairman or chief executive. The senior independent director should also have the authority to initiate such discussions through calling a meeting of the outside directors or sounding out investors.

Normalising communication between outside directors and shareholders will lead to a better understanding by both parties as to the objectives and constraints to which each works. An additional benefit in establishing direct channels as a

matter of routine is that it should enable difficult issues to be aired before a crisis develops.

The senior independent director should also take a lead in ensuring the board is functioning as effectively as possible. He or she should be responsible for completing a periodic performance appraisal of the company chairman (more on this below) and the board as a whole and the individual members where the chairman combines the role of chairman and chief executive or has been an executive director of the company in the past.

8. 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 NEDs?

Hermes believes that all directors need to obey the same general principles or duties. Anything else would fundamentally breach the principle of the unitary board system. Hermes welcomes the requirement under the proposed statutory statement for directors to exercise their independent judgement, although it was hoped that they would do this without it being a statutory requirement.

One point of possible concern within the proposed statutory statement of directors duties is the one on care, skill & diligence. The first clause keeps directors to a standard of care of a 'reasonably diligent person' with the level of knowledge, skill & experience to be expected of a director in his position, which provides the let-out that courts will recognise that outside directors have a lower degree of knowledge of the business and so may not be required to exercise quite the same level of hands-on control. But the problem arises in the second clause: that any additional knowledge, skill and experience the individual has above the basic standard expected will also be taken into account. Whilst this need not be an issue in the area of directors duties itself, it may have a bearing when the Review is looking at widening the pool and looking for particular skills for individuals on, say, the audit committee. It is possible that this particular term will cause some nervousness if the UK were to move to the US Blue Ribbon-style requirement that one member of the committee must have proper financial statements analysis knowledge. It could result in a situation that those individuals were taking on a greater degree of liability than their colleagues, which may discourage strong candidates from taking on the position on the advice of their lawyers.

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 NE roles? Possible issues for comment:

9. What are the key skills, knowledge and experience which are needed by NEDs 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?

The skills, expertise and experience required of an outside director to perform his role effectively will depend on the company, its current circumstances and future direction and the overall skill-set of the board. An interest in and knowledge of business is essential as is a willingness to learn the specifics of the particular company and its sector. Members of board sub-committees should

generally have some expertise or experience of the nature of the work delegated by the board to the committee. The experience and expertise of the outside directors should complement that of the executives not substitute for it. One of the key roles for outside directors identified above is to provide expertise and experience which might not otherwise be available on the board or to the company as a whole. It is likely that each outside director would bring some expertise or knowledge of a industry, region, market or whatever which was of specific relevance to the company and its operations.

The need for this complementarity of skills and for each director to bring an addition to the skill-set available on the board at any one time emphasises the need for board evaluation to identify gaps in the current balance of the board. It also implies the need for a formal appointment process to find the individual who best fills the skill-gaps apparent at board level.

10. What personal qualities and attributes are needed?

The core personal qualities include a willingness to contribute to a team effort, an ability to influence others through debate, flexibility, common sense, and the courage to confront colleagues and stand on principle when appropriate. A willingness to ask questions, often the simpler – or more apparently stupid – the better, is also a vital quality.

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

Again, the optimal mix of experience and personal qualities on a board will be company-specific. A balance of power is essential as is the regular introduction of new members who bring with them fresh perspectives and perhaps new skill sets that might be more relevant to the company's changing circumstances. Diversity of experience and perspective is desirable to enhance debate. The chairman and chief executive in particular should ensure that there is a succession plan that supports an optimal board composition. A periodic assessment of the performance of the board and its individual members would highlight for the chairman any gaps in expertise, experience or personal qualities.

While we are aware of a number of instances where outside directors have made outstanding contributions, we will refer to just two that have already become public to avoid embarrassing or compromising individuals.

The first instance was at Mirror Group Newspapers in late 1998 and early 1999. The outside directors on the board were increasingly uncomfortable about the corporate strategy and had formed the view that the then chief executive, David Montgomery, was not the man to take the company forwards in a focussed way. In particular, they were worried at the failure of discussions about a merger, which they believed was one route out of Mirror Group's strategic position. Under the chairmanship of Sir Victor Blank, the outside directors were prepared to confront the problem, and take the tough decision of seeking the removal of Montgomery if he was not willing to resign. A strategic review following his departure which prompted a number of disposals and also led to Mirror Group

entering into the merger which had previously failed to be completed on more favourable terms to Mirror shareholders than had previously been available.

The second instance was the events at Tomkins in late 2000. Hermes had been working with the company for well over a year, encouraging the enhancement of the board with additional strong outside directors. In October 2000, then CEO Greg Hutchings left the company amid allegations of inappropriate use of company funds. It took Tomkins over a year to appoint a replacement for Hutchings. The fact that the chairman, David Newlands, had the spare capacity to become executive chairman in the interim, and the fact that he had sufficient well-respected independent outside directors alongside him ensured that the company did not fail during this hiatus but in fact prospered. The need for outside directors to be able to devote extra time to companies in circumstances where problems arise is a key issue in determining how many roles an individual can sensibly accommodate without risking being overstretched.

12. How easy is it to recruit NEDs with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?

Hermes hears varying accounts of the degree of difficulty boards experience in recruiting new members. Companies seeking a very narrowly defined skill-set will of course have more difficulty recruiting a director than those seeking a generalist. However, in Hermes' view some of the apparent scarcity of appropriate candidates is the result of there not being an efficient recruitment market for outside directors. Hermes has outlined in its Corporate Governance policy its views on the role of the Nomination Committee. Further, Hermes believes that the recruitment of the outside members of the board should be afforded the same rigour as the recruitment of a senior executive director. Networks are still used to a considerable extent to identify candidates. Whilst this can be a very effective method of recruiting new board members it is essential that a formal and transparent process has been followed and that the candidate appointed is going to make a contribution at the board table. A "job description" should be drafted in which the skills, experience and personal qualities sought are outlined and the role of the appointee explained.

The nominations committee should consider retaining a recruitment specialist to draw up a list of candidates for interview which may well bring in candidates that would otherwise not have been identified. A newspaper advertisement can be a simple and inexpensive way of accessing a broader pool of candidates. Hermes is aware that a building society which recently advertised an outside director role received a wave of applicants, a number of whom will have proved suitable.

13. What could be done to widen the pool of potential NEDs and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?

Please see above. Perhaps the biggest obstacle to greater diversity on boards is human nature. People identify best with people like themselves. There is a tension between achieving diversity and "goodness of fit" when introducing new members to any group and it is the mark of a good chairman when a board achieves this balance. It is vital both that the board is able to work cohesively and that a genuine diversity of views is heard and respected.

Increasing the level of international representation on UK boards would potentially widen the pool of candidates but only makes sense if it is done for business reasons and not for the sake of diversity. The perspective of those with experience of non-UK companies would be insightful but must be weighed against the potential for language and cultural barriers to hinder the contribution of individuals. Further, for international candidates with executive commitments in their home market the requirement to travel to board meetings in the UK is often a barrier to taking on the position.

14. Are the rewards for NEDs appropriate, both in terms of levels of pay and the form that remuneration takes — eg cash/shares/share options? Are current pay levels a significant factor in whether good NEDs can be attracted?

Hermes supports the remarks on outside director rewards made in the Cadbury Report over a decade ago. “On fees, there is a balance to be struck between recognising the value of the contribution made by non-executive directors and not undermining their independence. The demands which are now being made on conscientious non-executive directors are significant and their fees should reflect the time which they devote to the company’s affairs. There is, therefore, a case for paying for additional responsibilities taken on, for example, by chairmen of board committees. In order to safeguard their independent position, we regard it as good practice for non-executive directors not to participate in share option schemes and for their service as non-executive directors not to be pensionable by the company.”

Contrary to public perception, institutional investors are not necessarily against increasing pay levels or against high absolute pay; what we seek is a close correlation between returns to shareholders and returns to, or the pay of, the shareholders’ agents, namely board directors. Hermes is aware of concerns that the fees paid to outside directors are generally too low and that this is having a negative effect on the number of suitable candidates who are willing to put themselves forward for consideration for board positions. Investors are frequently told by recruitment agents and companies that the problem stems from the relative attractiveness of being a freelance consultant to the company. As a consultant, the individual has less legal liability, more flexibility in terms of projects taken on (ie they are not always on call) and can earn more.

One way to increase the fees paid to outside directors and at the same time align their interests with those of the shareholders is to pay them partly in shares to be retained whilst they hold office. Hermes is strongly of the view that share options are not appropriate for outside directors. Options are a contingency payment and align the interests of the outside directors with the executives rather than with shareholders.

The review team might be interested to read a US study on the performance effect of outside directors holding shares entitled *Outside Directors with a Stake: the Linchpin in Improving Governance*. In it the authors, Hambrick and Jackson, of Columbia University, show that the best performing companies in the sample groups were led by outside directors who held as much as five times the number of shares as those of the poorest performing companies. As one outside director interviewed for the study observed: “I’m convinced that having a significant financial stake in the company affects the alertness and behaviour of directors. I’ve seen it in others, and I’ve seen it in myself. You seek more information, you spend more time with the information, you ask more questions, you probe much

more. And, best of all, the CEO knows you're super-interested, and so he does a better job too."

15. Do you have comments on the issue of risks or insurance provision for NEDs?

The real risk to outside directors is a reputational one and not something that can be insured against, other than through the performance and integrity of the individual. Purchasing D&O insurance for outside directors is acceptable within reason.

C: Structures and accountability

Do existing structures and procedures facilitate effective performance by non-executive directors? Possible issues for comment:

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

Hermes believes that the Combined Code provides a sound market benchmark for best practice in corporate governance and that it is widely observed. It provides sufficient flexibility through its "explain and justify" philosophy so that companies and investors can accommodate different practices as appropriate to achieving the desired outcome, namely well governed companies that earn superior returns for shareholders over the long term. We believe that its status as non-compulsory best practice reflects well the constant need for flexibility and pragmatism in corporate governance matters. In this light, Hermes welcomes the government's stated intention not to legislate but to leave such matters in the realm of best practice guidelines. It is difficult to make a general comment on the effectiveness of the balance between outside directors and executive directors, and as already noted, Hermes believes that to a large extent the distinction is artificial: directors are directors.

That said, Hermes believes it is essential that there is a quorum of outside directors who are and are seen to be fully independent. The difficulty is that independence is, more than anything, a state of mind. And shareholders, who are responsible for electing directors to the board, must assess the independence of those whom they are unlikely to meet or see in action in the boardroom. Thus, criteria are necessary as in Hermes' experience all directors deem that they are independent. Although the Combined Code refers only to the principle of independence, the market has in practice developed a working definition of independence of outside directors. Hermes' own criteria are given in its Corporate Governance policy and are explained in more detail as follows.

· Be or have been an employee of the company

Clearly, a director of a group subsidiary company who is on the main board, whilst not an executive of the group company is clearly an executive director within the group. This has not, however, stopped some companies in the past trying to count such directors as part of their independent outside director component on the main board. It is quite widely accepted that after a reasonable

break in executive service with the company an outside director can be independent of his former colleagues. It is still preferable, however, that such executives become outside directors at other companies.

· *Serve as a director for more than ten years or be over 70 years of age*

Three three-year terms with a little leeway on either side seems to be a reasonable length of service for most directors. Anecdotally, we hear from both executives and outside directors that serving for more than ten years is generally undesirable, simply because “group think” does tend to set in. Hermes believes also that there is considerable value in regularly introducing new directors to the board who bring with them fresh perspectives and often provide an opportunity to expand the set of skills and experience on the board to suit the changes made in the board’s strategy and operations over the preceding several years.

On the age of directors, we do not believe that someone becomes less valuable simply on the passage of time, but it is right that every individual appointment of a director over 70 should be justified. Arguably, it can be more difficult to resign from a last public appointment on a matter of principle; given that an individual over 70 will have a reducing number of such appointments, and as resignation is the ultimate sanction against poor board practice, we want to be confident that all the outside directors are inclined to use it if the situation so demands.

· *Represent significant shareholders or other single interest groups (eg supplier, creditor, employee)*

Board directors should represent the interest of all shareholders and should take into account the interests of all stakeholders. Representing single interest groups implies that a director has an allegiance more to one group than to the whole. Such directors should be acknowledged as non-independent.

· *Receive an income from the company other than outside director fees.*

Some outside directors act as consultants to the company and earn a consultancy fee. We prefer directors to be either directors or consultants. The two roles, whilst having some overlap, have quite different responsibilities. To take independent decisions an outside director needs to be objective. If the board is reviewing advice given by him or her as a consultant it is doubtful this can be the case. Further, on the matter of fees, if an outside director is earning a considerable income through their consultancy work it is possible that he will be overly financially dependent on the executives, thereby further impinging on his ability to be independent of them in his judgement.

· *Participate in the company’s share option or performance-related remuneration schemes*

One of the critical roles the outside directors play on the board is assessing the structure and levels of performance pay that should be awarded the executive directors. If the outside directors also participate in performance pay it is firstly unclear who would then determine the levels of pay to the board as a whole but more significantly would align the interests of the outside directors more closely with those of the executives than of the shareholders.

· *Have conflicting or cross-directorships*

Again, it is essential that the outside directors see their role as representing the interests of the shareholders. Being beholden to other directors through directorships at other companies is not acceptable.

· *Have any other significant financial or personal tie to the company or its management which could interfere with the director's loyalty to shareholders*
This of course is extremely difficult to observe from the outside. However, in certain situations where shareholders get to know the directors better, these relationships usually become apparent.

17. Do the recommended structures for board committees facilitate governance and an effective contribution by NEDs? Are board meeting procedures working effectively? Do you have comments on board size?

The recommended structures have the potential to work as anticipated as long as sufficient time is allocated by directors to the tasks for which they are responsible. Thorough preparation for board and sub-committee meetings is essential for the effective governance of companies within the UK's self-regulated framework. Board meeting procedures differ across companies so it is difficult to say whether they are effective for the market as a whole. Professional bodies such as the Institute of Directors and the Institute of Chartered Secretaries and Administrators have contributed to improvements in board practices, and will no doubt continue to do so. Hermes has no view on the ideal size of a board but is not in favour of over-large boards. It is for the board itself to explain and justify its size and composition within the context of the company's specific circumstances, though we note the results of a study entitled *Entrepreneurship in Medium-Size Companies: Exploring the Effects of Ownership and Governance Systems* by Zahra, Neubaum and Huse, which found a downturn in performance by companies with boards larger than 11 members. As ever, the best companies have adopted the structures and benefited. This encourages others to follow but the laggards need more convincing to adopt best practice and that is the responsibility of shareholders.

18. 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?

Hermes believes that audit committees have the core role in ensuring that the audit is carried out thoroughly and that the auditors retain their independence from management. Typically, this will already be plain in the audit committee's terms of reference. To our minds, carrying out these obligations will require the committee to:

- annually conduct a meaningful evaluation of the audit services and the relationship between the auditor and the corporation's directors and officers
- ensure they establish and maintain independent channels of communication with the auditors, including other members of the audit team in addition to the engagement partner when appropriate
- have a clear policy, supported by effective processes, to ensure the provision of non-audit services by the auditor and its affiliates does not affect the auditors' independence, perceived or real
- annually consider the re-appointment of the auditors, and make an appropriate recommendation to the Board and or to the shareholders as appropriate, and also ensure the regular rotation of the audit partner and other audit staff
- consider the benefits of seeking tenders for the audit at regular and appropriate intervals, paying particular regard to the quality of the audit and not just its cost

- have access to independent sources of advice, including but not limited to technical accounting advice. This advice should be sought and obtained whenever the audit committee deems it necessary
- approve employment policies designed to prevent conflicts of interest arising from the interchange of personnel between the audit team and corporation's audit-related staff

The best audit committees already carry out these roles. Better disclosure of audit committee activities by all companies, making clear that they fulfil these duties (and providing a fuller breakdown of audit and non-audit fees and the audit committee's role in overseeing awards of non-audit contracts to the auditors) would provide investors with enhanced confidence.

On the issue of audit committee composition, Hermes believes there may be some value in the UK considering the recommendation of the US's Blue Ribbon committee that at least one member of all audit committees have proper expertise in analysing financial statements. We believe that those without such experience should receive training to assist them in carrying out their duties. But we again note that the section on directors duties in the Company Law consultation may militate against such steps because those with the expertise and training which would help investors have confidence in their ability to carry out their role may open themselves to greater liability.

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

The work of the remuneration committee is amongst the highest profile of all the sub-committees, and because of this probably the most onerous, particularly at larger companies. It is widely accepted that remuneration committees of independent outside directors are best placed to determine the remuneration policies most appropriate for the company and its senior executive team. But equally, shareholders have a legitimate interest in performance-related aspects of such policies as they generally involve the commitment of equity over a number of years and are the means by which directors are incentivised to achieve, and rewarded for achieving, superior long-term shareholder returns.

Achieving a balance between the interests of the executive directors and the shareholders is the responsibility of the remuneration committee. In large part, this requires considerable communication with shareholders and in Hermes' experience, if under-resourced or misdirected at the start, can be an issue over which shareholders and the board will most commonly disagree publicly. The most important message to get across is the link between the structure of proposed pay schemes and company strategy and long-term performance. One of the most difficult aspects of a pay policy to understand from the outside is the context within which it fits at the company and the specific issues that the remuneration committee and board faced in setting the policy. Most remuneration committees, and the chairman of the committee in particular, need to be more willing (and better able) to communicate openly with shareholders on pay proposals, and explain and justify schemes. Too often, too much is left in the hands of remuneration consultants, who will understand company strategy and other internal issues less well than board members. If the outside directors on the remuneration committee cannot explain the proposed pay scheme and how it fits with the company's strategy, it will be hard for investors to understand how the scheme will incentivise executives to fulfil the board's strategic aims and so drive shareholder returns.

To help bolster investor confidence, remuneration committees should consider hiring their own remuneration advisers, who are independent of any other role with the company. Taking the advice of such fully independent consultants might help ensure a tighter link between pay structures and strategic aims.

Beyond the drafting of the job description and the identification of the candidates discussed under Q12, the nomination committee has three other important functions. Firstly, once the short-listed candidates have been introduced to the board, the nomination committee should take a leading role in ensuring that the prospective board members are able to gain a good sense of the way the board works and the demands of the role. Most likely, this will be achieved through an extensive discussion with the chairman and possibly the chief executive. It could also prove fruitful for the short-listed candidates to spend some time with the company secretary. This should minimise the risk of impossibly mismatched expectations and working styles.

Secondly, once the appointment has been made, the nominations committee should ensure that all board appointees undergo an appropriate induction and introduction programme. It can take as long as two years for a new outside director to become fully conversant in the topics raised at board meetings. Actively assisting newly appointed outside directors to build their understanding of the company and the board shortens their “apprenticeship”.

Finally, probably one of the more important but overlooked responsibilities delegated to the nomination committee is to keep a watching brief on potential successors for the top positions on the board. This is achieved through the outside directors meeting and getting to know executives in the first and second tiers of management outside the boardroom in the case of the chief executive role, and maintaining a general interest in the performance and availability of senior business people outside the company in the case of the chairman’s role.

In terms of the composition and role, the nomination committee should have majority of independent outside members and, in general, the chairman and senior independent director should be members. The degree of involvement of the chief executive is a decision for the board but it would be unlikely that he would want to be totally removed from the process. The remuneration committee should have as members only fully independent outside directors. Both committees should normally be chaired by a fully independent outside director. Membership of the committees should be disclosed in the annual report. In recognition of the importance of the committees’ work in ensuring the best practice is observed they should be formally constituted as sub-committees of the main board to whom they are answerable and to whom they should report. They should be given written terms of reference which deal adequately with committee membership, authority and duties.

- 20. What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?**
- 21. 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 NEDs?**

Hermes is aware of only a few companies that have formal performance evaluation processes in place for the board and only two which evaluate the performance of individual board members. These two companies have the same chairman. Hermes encourages investee companies to carry out a periodic and formal performance review of both the board and the individual directors. The chairman that carries out such evaluations says he could not run the boards as effectively without them. In particular, it is very useful for him to have a formal opportunity and basis for discussions with underperforming directors. Hermes is encouraged that a number of consultants in addition to the Institute of Chartered Secretaries and Administrators have developed services to assist boards with such evaluations. Hermes supports boards making a statement to the effect that such a review has been done but believes it would be inappropriate for details of the recommendations of the review or the performance of individuals to be made public.

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

As already noted, outside directors are in a position to prevent small problems escalating into crises and, on well chaired and properly functioning boards, should be able to challenge executive proposals and decisions. The ultimate weapon of the outside director who believes that the wrong path is being taken is to resign. Perhaps more outside directors should use this and should make public their reason for quitting the board.

Of course, the alternative to resignation is to stand firm, and to seek the assistance of institutional investors, in the way that Sir Victor Blank and the other outside directors did at Mirror Group. If the situation demands, outside directors should be ready to counter executive actions that are damaging to the company by actively seeking the support of institutional investors. Hermes has some experience of such situations and believes it is incumbent on outside directors to be more proactive in addressing performance problems in collaboration with shareholders before the company suffers permanent set-backs. Most fund management houses now have staff that would be ready to discuss such matters with any outside director that contacted them.

D: Relationships with shareholders and others

Do existing relationships with shareholders or others need to be strengthened?
Possible issues for comment:

23. How well do relationships between NEDs 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 NEDs and institutional shareholders. How could this relationship be strengthened?

Hermes has for some time encouraged more frequent contact between outside directors and institutional investors (by which is meant the long term investors such as pension and mutual funds rather than broker analysts). Hermes does not suggest that there should be a formalised, say annual, "outside director roadshow" but that outside directors should be willing to meet with those long-term investors who take an interest in better understanding the board from the outside directors' perspective. Hermes believes that newly appointed outside directors should as part of their induction meet representatives of the leading institutional investors in the company and should make themselves available in the margins of the first AGM they attend to meet private investors, and possibly stakeholders. Such meetings with institutional investors would provide a backdrop for any discussions the outside director later thought necessary to safeguard the company's long-term success (as discussed above). Outside directors should also consider attending, if not participating in, meetings between the senior executive team and any significant stakeholder group (say unions or NGOs) in order to gain at first hand a sense of the issues faced by the company.

24. To what extent are Chairmen creating the conditions for NEDs 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?

As an institutional investor, Hermes is not privy to board discussions and is therefore unable to say to what extent Chairmen are creating the conditions for outside directors to be effective. In our experience, however, the success of a board does tend to rest on the effectiveness of the chairman and his ability to create a cohesive team in which constructive criticism and frank debate are encouraged. Critical to this is trust and respect amongst the members of the board and this is generally only achieved over time and with commitment. The senior independent director can, alongside the chairman, play an important role in developing this trust and respect.

25. What should be the relationship between NEDs 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 advisers to the company?

Outside directors and the executive team should know one another well enough to build confidence in each other's ability and to assess one another's performance. Outside directors should know the senior management well enough to be able to seek information directly from them and to be able to identify potential successors to members of the executive team. Outside

directors are more likely to be closer to the chairman than to the chief executive but their relationship with both should be open and frank. Outside directors should know the key advisors to the company well enough to seek information on the company and its performance directly from the advisors if needs be and to be able to assess the performance and the calibre of the advisors.

26. How can Company Secretaries support effective performance by NEDs?

Company secretaries can play a vital role in supporting outside directors through giving advice on board procedures, company precedents and regulatory requirements and ensuring information provided to the board is complete and impartial. As ever, within companies committed to good corporate governance practice, company secretaries are already fulfilling this role to great effect but at many companies the company secretary is something of an under-used resource. At the best companies, the secretariat is seen as a unit largely independent of the executive, and answerable more to the (independent) chairman and the other outside directors. Where this is not the case, outside directors should perhaps seek the counsel of their company secretary more proactively if they believe that the service they receive from the secretariat could be improved. The company secretary tends to be the first point of contact for investors who wish to raise governance issues, so he or she might be the best route for facilitating contact between the outside directors and concerned shareholders.

E: Support

How can non-executive directors best be supported to perform their role? Possible issues for comment:

27. How much access to information from management do NEDs need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?

Only the outside directors on the board of a company can say how much and what information they need to be effective within the context of that company. They have to be sure that they are receiving sufficient information of the right sort to enable them to participate on a fully informed basis in the discussions at board meetings. Often quantity is not the problem but quality and focus is. Like much of the governance disclosure produced in annual reports and accounts, unnecessary volume makes the information difficult to digest and, to a cynical reader, suggests something is being buried. It would seem that this is particularly true of the non-financial aspects of the company's performance. As already noted above, the company secretary can provide an essential source of information, especially in terms of assessing and maintaining a balance of backward- and forward-looking papers and the independence of the information on the aspects of the business of particular interest or concern to the outside directors. The chairman, who will generally be more involved in the daily aspects of the business than any of the other outside directors, should also ensure that the board papers give a true picture of the company and its direction. It should be a part of the annual review of the board's performance as to whether the formal information provided the board met the members' expectations and

requirements, though directors should not wait until the end of the year to raise concerns.

Board papers and briefings by executives at board meetings are not the only sources of information. Outside directors should not underestimate the value of information gathered on their own initiative, through their contacts with other directors (both internal and external to the company) and, where applicable, through being a client or customer of the company. The board of Marks & Spencer might have spotted the problems it faced sooner if any member of the board had been closer to the company's target customer demographic. Site visits and away-days are equally valuable, especially for meeting senior management and employees below board level. Public sources of information such as brokers' reports and media coverage of the company can also be useful, particularly in reflecting outsiders' perspectives and concerns.

28. What training and development opportunities are available? Could they be improved and, if so, how?

It is a peculiarity of board practice that once a director reaches the most senior level in his career, structured or formal professional development ceases. There is clearly a need for outside directors to be trained in the specialist areas of their responsibilities, particularly on audit and remuneration issues if they happen to serve on those sub-committees of the board – though we note again the unwelcome risk that the current draft of directors' duties in the Company Law consultation implies that this might increase their personal liability. Equally there is a need for new outside directors to be alerted to the quite different role they play from that of an executive director. There are a number of programmes offered by management colleges and outside director training specialists, many of which use case studies to highlight for the outside directors the complexity of the role. Alternatively, awareness of best practice can be gained through company-specific workshops and facilitated evaluation of board practice, rather than necessarily attending classes. Networking with other outside directors and attending the events hosted by corporate advisors at which topical issues are discussed can also be fruitful. Outside directors should take the lead in promoting continuing professional development by encouraging the company to take a more pro-active approach to training the executives, as well as the outside directors, in the art of being a director. Boards are only as good as the members of them and the ability for the whole board to be greater than the sum of the parts is one of the reasons for having them!

To assist outside directors, consideration should be given to developing a professional body or institute specifically for them. While the Institute of Directors already plays an important role in this field, the majority of its members are directors of small private companies and so its activities are not necessarily entirely in tune with the needs of outside directors at public companies.

29. Can induction for NEDs be improved?

As induction is an especially company-specific activity it is difficult to say whether as a whole it could be improved. Certainly, all companies should have an induction process through which new board members can get to know the company and its operations. It is essential that this is more than just a whistle-stop tour of departments or subsidiary companies. It should extend over a period of months and the outside director should be prepared to commit the time

to getting a thorough understanding of the business and the board. As mentioned above, the induction should include a series of meetings with a good number of institutional investors.

30. Do NEDs get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?

As already noted above, Hermes is aware of only two companies that have formal evaluation of board member performance. As to guidance, the suggestion made above that boards have a specific outside director terms of reference document if adopted would go some way to ensuring that outside directors were aware of what was expected of them.

F: Smaller listed companies

In what ways is the position different for smaller listed companies? Possible issues for comment:

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

Hermes is aware that smaller listed companies often experience greater difficulty in recruiting outside directors, particularly if the company is based outside South-East England. For that reason, our independence criteria are applied slightly more flexibly than for larger companies and we accept that board sub-committees might not always be constituted in accordance with our general principles. But we believe strongly that smaller companies should seek to have high calibre outside directors, who after all provide good value for money if exploited to the fullest.

Hermes would not support formal special provision for smaller companies. As the Combined Code is a best practice guideline, it is generally accepted that not all companies will achieve full compliance. Most investors are particularly flexible and pragmatic in applying their guidelines to smaller companies, so there should be no need for special provisions. In any case, failures to comply in full are entirely consistent with the current comply or explain regime. Certain recommendations in this response will be difficult to apply at some companies. Most notably the greater relationship between the company secretariat and the outside directors will be difficult to achieve where the company secretary role is taken by the finance director, as is often the case at smaller companies.

G: International context

What can we learn from international experience? Possible issues for comment:

- 32. What lessons can be learnt from international experience, either in terms of structures or behaviours?**
- 33. Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?**
- 34. Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?**

The main lesson to be learned from the international context is that corporate governance in the UK is well-developed and embedded. The UK is fine-tuning what is already a fundamentally sound system. That said, Hermes recognises that there are practices observed abroad that could enhance UK corporate governance. Whilst not in favour of special interest group representation on boards, as is common in some Continental countries, Hermes believes it is essential for the long-term success of the company that boards have a thorough understanding of stakeholder concerns. Boards may therefore deem it appropriate to introduce formalised mechanisms for board-stakeholder dialogue. In terms of board structure, the UK model of approximately equal numbers of executive and outside director members has the advantage that those responsible for the strategic direction of the company and for the oversight of the management can have strong relationships with those responsible for the day-to-day running of the company outside the boardroom. They are able to influence the debate rather than rubber stamp decisions already taken at the functional level.

The wholesale introduction of structures from foreign markets would be problematic because the individuals who would have to operate within them are not familiar with such structures. For example, UK directors understand and drive value through the unitary board because they know the structure and how to make it function. Abandoning it would therefore be risky and inadvisable.

September 2nd 2002

Appendix I: Hermes Guide for shareholders and independent outside directors

Appendix 2: Hermes Statement on UK Corporate Governance and Voting Policy
2001