

THE HIGGS REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS

Response by London Stock Exchange plc

EXECUTIVE SUMMARY

General Views

- UK is uniquely situated to influence the international debate
- Safeguard the balance and integrity of the UK model
- Support the best practice approach
- Support full transparency, disclosure and accountability of corporate governance
- Commercial exchanges have no role to play in enforcement

Section A: Role

- Continue concept of unitary Board
- The Board directs rather than manages the business
- Chairman and NED roles need to be more clearly defined in best practice guidance
- NEDs should not have specific roles or portfolios
- Full disclosure of number of Chairs and NEDs that one individual holds
- A balanced mix between NEDs and Executive Directors is important

Section B: Attracting and Appointing NEDs

- NEDs should have generic job descriptions and objectives
- No extension of the proportion of independent NEDs on the Board
- Remuneration of NEDs should be appropriate to their responsibility and commitment
- NEDs should not be remunerated through share incentive schemes

Section C: Structures and Accountability

- The Combined Code has worked well in practice
- Audit Committee should be strengthened
- Audit Committee should comprise wholly independent NEDs
- Audit Committee should publish an audit statement in the Annual Report

Section D: Relationships with shareholders and others

- NEDs to make themselves available to institutional investors on ad hoc issues
- Chairmen of Committees should be able to call on the same outside professional expertise as Executive Directors

Section F: Smaller listed companies

- Support “Comply or Explain” best practice for all listed companies

Section G: International Context

- Support the concept of super-equivalence within the European Union
- Sarbanes-Oxley is too prescriptive for US-listed UK companies

INTRODUCTION

London Stock Exchange plc (“the Exchange”) welcomes the opportunity to put forward its views on the role and effectiveness of Non-Executive Directors (“NEDs”).

The Exchange listed on its own market in July 2001. The Exchange is now operating on a fully commercial basis and our sole regulatory responsibility is as one of eight Recognised Investment Exchanges under the Financial Services and Markets Act 2000.

In May 2000, following the demutualisation of the Exchange into a commercial company, responsibility for the UK Listing Authority, the body that approves the official listing of companies, was transferred from the Exchange to the FSA.

Our submission reflects our two interests in the Higgs Review (“the Review”):

1. First, as a fully commercial listed company in our own right, we believe high standards of corporate governance are necessary to attracting investors and promoting confidence in the company.
2. Second, as the leading stock exchange in the UK and Europe, we believe high standards of corporate governance contribute to investor confidence in our markets and enhance their quality and attractiveness to domestic and international companies and investors.

LONDON STOCK EXCHANGE PLC BOARD STRUCTURE

For the Review’s information, we attach as an Appendix the Exchange’s Corporate Governance Report from our 2002 Annual Report.

CORE PRINCIPLES OF UK CORPORATE GOVERNANCE

The Exchange has supported the principles behind the development and introduction of the Combined Code – Principles of Good Governance and Code of Best Practice (“the Combined Code”). We see the four core principles of the successful UK model as:

- The non-statutory, best practice, principles-based nature of the Combined Code, which allows for flexibility without recourse to further legislation.
- The unitary nature of the Board.
- The split between the roles of Chairman and Chief Executive Officer.
- The increasing importance of the role of NEDs.

The Government and the Review have stated that an approach based on best practice rather than regulation or legislation is their preferred starting point. We support continuation of the best practice approach.

GENERAL VIEWS

- The Higgs Review is just one element of the corporate governance initiatives currently taking place in the UK, Europe and the United States.
- The UK has in recent years taken steps to improve governance standards, in part as a result of past corporate scandals. Various independent corporate governance reports now show UK companies ahead of their competitors in the US and Europe. As such, the UK is uniquely situated to lead the international debate¹. Through the Review and the reform of company law, we must either influence the debate to promote the strengths and values of the UK model overseas or at least safeguard it from harmful supra-national public policies.
- It is important that UK standards have a sponsoring body that can protect and promote our standards worldwide and input to the wider international debate on the best approach to governance. We believe we suffer from the diffuse number of organisations (UKLA, FRC, FRRP and investor groups) that have either formal or informal responsibility for reviewing and enforcing the Combined Code. We therefore support the Government's proposed establishment of a new Standards Board to review and make rules concerning the Combined Code.
- As opposed to the contrasting European and US approaches² to corporate governance, we believe the UK model strikes the right balance for listed companies, setting high standards of accountability, transparency and disclosure, adopted in best practice and sanctioned by the market (mainly investor groups).
- In terms of developing the UK model, we do not believe it is possible to legislate for ethics and there are real dangers of seeking to do so. The issue we seek to address through this submission is how to reinforce the existing sanctions, outside a legislative framework, to maintain and promote high standards of corporate behaviour.

¹ See the UK's leading position as measured by Deminor Rating, an independent European consultancy, and Davis Global Advisors: "Leading Corporate Governance Indicators".

² See Section G, page 8.

- Our view is that this can best be achieved through increasing the level of accountability, transparency and disclosure. As is currently the case under the UKLA's listing rules in relation to the Combined Code³, either a company complies with best practice or it must explain its position to its shareholders, prospective shareholders and investor groups. They can then make more informed investment decisions as to where to allocate their capital.
- We do not believe it is appropriate for commercial exchange organisations to play a role in enforcement of the Combined Code or corporate governance more generally. This is a public policy issue that should be overseen by regulatory bodies with clear public accountability.

SECTION A: ROLE

- Q1
- The Board's overall role is to direct rather than manage the business and we do not believe there should be any infringement of this concept.
 - As part of the best practice approach, we do not believe that the role of the Chairman or NED should be defined in legislation, or carved out from the general definition of Director. This would move away from the concept of a unitary Board. However, we believe it would be useful for the Review to produce further best practice guidance on the main responsibilities of the Chairman and Directors. This would be along the lines of the guidance issued to Pension Fund Trustees following Myners, and against which Boards could measure their compliance. In particular, we believe it would be helpful if the main responsibilities of the critical role of Chairman were more clearly set out.
 - These responsibilities should focus on forging and managing the Board, including ensuring that it has easy access to appropriate information. The Chairman is likely to have much closer day-to-day access to the business than the NEDs and should be informed enough about the business to ensure that he/she has mechanisms in place that would provide early warning about issues in which the Board should be involved. The relationship and communication between Chairman and Chief Executive is therefore vital.
- Q2
- We believe it would be useful if the Board set out clearly in writing the necessary skills and attributes of the Chairman of the Audit Committee and perhaps Chairman of the Remuneration Committee.

³ Paragraph 12.43A, UKLA, The Listing Rules.

- The balance on a Board between NEDs and Executive Directors is also a significant factor in determining the effectiveness of NEDs. We believe the UK model of appointing a more equal number of the two is more helpful than say the US model where the NEDs are several times the number of Executive Directors.
- Q6 ● We believe it is difficult for one individual to be a Chairman or (in particular independent) NED of a large number of companies. However, we believe the best deterrent to abuse in these cases would be total disclosure rather than prescribing an upper limit. At present, there is no obligation to disclose all current directorships in the Annual Report and we would support disclosure of all directorships.
- Q7 ● We would support a special role for a “senior independent” NED, who would support the Chairman and act as another safeguard against abuse. The senior independent NED would then have two primary roles:
- Give the Chairman feedback about how he/she manages the Board and coordinates the contribution of NEDs (including an annual appraisal⁴).
 - Point of contact for Board members or investor groups, such as institutional investors, that are unhappy with their relationship with the Chairman.⁵

SECTION B: ATTRACTING AND APPOINTING NEDS

- Q9 ● The majority of NEDs should be recruited with specific skills to meet the needs of the company. For example, members of the Audit Committee in particular should have the necessary skill and experience to challenge management and external auditors on accounting and financial issues. There should still be a role for the “generalist” (with general business skills) who remains valuable to the overall mix of NEDs.
- We believe it would be useful for the Review to compile guidance on the skills, knowledge and experience that are needed by NEDs.
- Q10 ● We support and follow best practice that the majority of NEDs on the Board should be independent. We do not believe that this principle needs to be extended further. As well as being independent, it may

⁴ See below, Q20, page 7.

⁵ A.2.1, Combined Code already states: “... there should be a strong and independent non-executive element on the board, with a recognised senior member other than the chairman to whom concerns can be conveyed.”

also be helpful for some NEDs on the Board to possess current relevant experience of the sector in which the company operates.

- Q12-13
- It is clearly in the interests of improving the effectiveness of NEDs that sufficient numbers of quality individuals are prepared to take on this role. A greater marketplace of talents must be created. The bottom line is that unless individuals are properly rewarded – commensurate with their time and risk commitment – they will look elsewhere.
- Q14
- The remuneration of NEDs should therefore be appropriate to their level of time and commitment and this is a judgement for individual companies to make.
 - In terms of remuneration, it is not advisable for NEDs to participate in a company share option scheme, as this would compromise their independent status.

SECTION C: STRUCTURES AND ACCOUNTABILITY

- Q16
- Our view is that the Combined Code has worked well, particularly in developing the distinct roles of Executives and NEDs. We believe that the recommended structures for Board committees do facilitate good governance and an effective contribution by NEDs.
- Q18
- We do believe, however, that the role of the Audit Committee should be strengthened. The Combined Code currently says Audit Committees should comprise a majority of independent NEDs⁶. We support Audit Committees made up wholly of independent NEDs, as is the case with the Remuneration Committee.⁷
 - Again, as with the Remuneration Committee, the Annual Report should contain a statement of audit policy and details of how financial reporting and internal control principles have been applied and how an appropriate relationship with the company's auditors have been maintained. This would replace the "internal controls" section of the corporate governance statement.
 - The statement could include, for example:
 - Annual review of all dealings between the company and the audit firm
 - Annual review of the make up and balance of the Committee and its access to financial information
 - Disclosure of separate meetings between independent NEDs and auditors without Executive Directors/management.

⁶ D.3.1, Combined Code.

⁷ B.2.1, Combined Code.

- Q20 • It should be regarded as best practice that the Board has an annual appraisal of its own performance. This would be the responsibility of the Chairman, who should himself be appraised annually by the Senior Independent NED⁸.

SECTION D: RELATIONSHIP WITH SHAREHOLDERS AND OTHERS

- Q23 • The Chairmen of the Remuneration and Audit Committees, in particular, should be able to call on the same outside professional expertise as the Executive Directors.
- Q25 • NEDs, particularly the Chairmen of the Audit and Remuneration committees, should make themselves available to institutional investors on ad hoc issues such as remuneration and internal controls. These should be planned and coordinated with the Chairman and Chief Executive.
- NEDs should be encouraged to inform themselves about areas of the business in which they have a particular expertise. This expertise would then be available to Executive Management and it would materially help the NED in his/her oversight function.

SECTION F: SMALLER LISTED COMPANIES

- Q31 • In terms of overall regulatory policy, we support a flexible approach for smaller quoted companies. This was a prime reason for the establishment of our AIM market in 1995 and has guided our response to recent UK and European regulatory consultations. AIM companies are not “listed” and therefore are not required to make disclosures about the extent to which they adhere to the Combined Code. We support continuation of this policy.
- In the case of UK corporate governance, however, we do not believe there is a need to differentiate between smaller and larger listed companies and we therefore support “Comply or Explain” best practice. If smaller companies are not able to follow best practice, they should explain their position in the Annual Report. As the company grows, it should be increasingly able to comply with most if not all of the provisions of the Combined Code.

⁸ See above Q7, page 5.

SECTION G: INTERNATIONAL CONTEXT

- Q31-34 • The Exchange is concerned by the range of different corporate governance regulation and legislation emanating from different jurisdictions, which will apply to international companies. We regard UK corporate governance as a good model, which can be further reinforced, but which is also uniquely positioned to lead the international debate on this issue.
- Q32-34 • In particular, we do not wish to see the high standards of UK corporate governance, as seen in the super-equivalent listing rules and the Combined Code, watered down by the imposition of maximum standards of EU governance without the possibility for "top ups" by member states. There is clearly a case for raising standards, not for lowering them.
- The United States has recently introduced the Sarbanes-Oxley Act of 2002⁹ following recent corporate scandals. Sarbanes-Oxley takes a regulatory and legislative approach to corporate governance, contrasting with the UK best practice approach that we support and regard as more flexible. One of its main provisions is to make a company's Chief Executive Officer and Chief Financial Officer personally responsible for its financial reports and for establishing and maintaining internal controls. In order to maintain the unitary concept, we believe that the entire Board should be responsible for approval of financial reports and for ensuring adequate internal controls.

12 September 2002

⁹ Sarbanes-Oxley Act of 2002, US Federal Legislation Concerning Corporate Governance, Accounting Oversight and Auditing.

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