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General Counsel & Secretary

Non-Executive Directors Review
Room 2142
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London SW1H 0ET

13th September 2002

Dear Sirs

Non- Executive Directors Review – Consultation Paper

We refer to the Consultation Paper released in June 2002 by Derek Higgs in the context of his review of the role and effectiveness of non-executive directors (“the Paper”) and to our conversation with your staff member last week in which it was agreed that we would submit our response today.

Our principal points and recommendations in response to the questions set out in the Paper are set out below. We have two initial observations as to overall approach:

1. We strongly favour the evolution of the existing “principles-based” approach to corporate governance best practice in the UK as opposed to the promulgation of a “rules-based” regime. We believe that the effectiveness of non-executive directors has been systematically enhanced over the last decade through the development and subsequent refinement of the Combined Code. We see no evidence of UK corporate failure at a level justifying a fundamental change of approach.

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2. Further refinement and development of the principles of UK corporate governance would in our view be best achieved by continuing to evolve standards of best practice, reflecting market sentiment but not reacting to short term exigencies local to particular industry sectors or a foreign market, and by focusing on fostering an environment in which people of integrity and competence are motivated to serve as independent directors.

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

1. The prime responsibilities of the board are to set the company's strategic aims, allocate human and financial resources appropriately, supervise and monitor the management of the business and report to stakeholders on their stewardship. The Chairman should take the lead in ensuring the effective operation of the board and serve as the public face of the company, particularly on governance and corporate social responsibility matters.

The Chairman's most routine interaction with both executive and non-executive directors will occur at board meetings, ensuring that debate and decision-making are suitably well informed and reflect the views of all constituents of the board. Taking note of recent developments in the U.S. we believe that there may be merit in Boards extending our own existing Audit Committee practice by arranging for non-executives to meet without non-executive directors present before or after each Board meeting. The Chairman would of course need to ensure that such sessions do not result in any executive director being less well informed than non-executive colleagues on matters falling within the responsibility of the Board as a whole.

Any conflict of interest on the part of a non-executive director can, and in our view should, be dealt with through the governance and regulatory disclosure mechanisms that already exist.

2. In our view the Combined Code adequately defines the necessary and appropriate role expected of non-executive directors, both in relation to monitoring management performance and the setting of stretching targets for the maximisation of return to current and future shareholders. The dynamics of an effective board are complex and depend largely upon the experience, judgment and to some extent the personality of the non-executive directors. It is not realistic to expect every non-executive to fulfil every aspect of the role. Long experience in public service, the professions or in business will give a non-executive valuable insights or perspectives to contribute more on certain issues than on others. Boards of the highest quality will comprise individuals with a range of backgrounds appropriate to the business of the company, supported by a conscientious and knowledgeable Chairman and backed by a secretariat dedicated to the meeting the highest standards of corporate governance.

3. Many UK companies are currently assessed by independent parties as meeting the highest standards of corporate governance, which include the appointment of an appropriate cadre of non-executive directors. The current principles are broadly adequate and compliance on the part of some companies needs to improve.
4. Whilst it is important to have a defined number of “independent” non-executive directors on a company’s board, it is also important to note that those directors who are deemed not to be “wholly independent” still have a valuable role to play. A clear definition of an “independent director” is needed. Currently there are a number of institutional/corporate governance bodies that have their own codes of best practice definitions for an independent director and it is therefore difficult for practitioners to adhere to all such codes.

We therefore recommended that the definition criteria applicable to directors’ independence in the current joint NAPF/ABI guidelines be used as a model for an updated definition. Companies wishing to appoint non-executive directors who fail to meet some of the criteria should be free to explain in their annual reports why they feel the appointment is nevertheless appropriate.

5. Included in other responses.
6. Whilst it is sensible for full-time executive directors to limit the number of external non-executive directorships they might hold, the number of non-executive positions held by a non-executive should not be prescribed. Nomination Committees need to be mindful of their obligation to ensure that appointments are on appropriate terms. The determining factor here should be the amount of time required to sensibly undertake the role and knowledge required to carry out the office effectively to enable value to be added to the organisation concerned. This is also applicable in the case of chairmen. Given that non-executive directors should by definition be experienced individuals of the highest integrity, each individual should be relied upon to assess the extent of his or her total commitment to each directorship and set an appropriate limit.
7. We consider that the current Combined Code provisions for a recognised senior member, other than the chairman, to whom concerns can be conveyed, together with the ability of non-executive directors to take independent advice, are adequate.
8. We agree with the underlying principles of the proposed statutory statement of directors’ duties. There is no distinction in company law between executive and non-executive directors in the context of conflict of interest. We believe that the current law is clear and appropriate.

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

9. Skills and attributes for people undertaking non-executive roles, which are well set out in recent NAPF guidance, include:
 - Extensive business experience.
 - Independence of mind and the robustness of character to display it.
 - Willingness to act as a sounding board, with the advantage of detachment.
 - Sufficient knowledge of finance to participate in board discussions on major issues of business development.
 - Possession of the level of management experience necessary to appraise the performance of the executive directors and top management team and ensure that appropriate succession plans are in place.
 - Ability to carry out specific corporate governance functions assigned to non-executive directors, via board committees, and ability to deal with conflicts of interest.
10. See (9) above.
11. There can be no magic formula guaranteed to produce an ideal board. What is required is a balance of skills, experience, age and personality, which reflects the needs of the business at a given time. Our company is a result of a demerger and benefits from a “custom-built” board assembled to run its business independent of its former parent. Senior management have benefited enormously from the external experience and contacts of the Chairman and non-executives, across a wide range of issues, from guidance with setting a vision and testing standards for the performance business to clear guidance on the highest standards of corporate governance. The ability of our non-executive directors to guide and their willingness to mentor has made a significant contribution to both our performance and governance. In the field of corporate governance for example, where constant commitment to matching best practice is essential, our non-executives have been able to facilitate introductions to many leading public companies in a manner enabling management to quickly and openly exchange ideas with their counterparts, to mutual benefit. This sort of dialogue simply could not take place as a result of “cold calling” between companies. For a “new” public company, this wide range of high level contacts has proved invaluable.
12. See above.

13. There is a finite pool of available senior executives and an inadequate supply of “younger” candidates. Companies should be encouraged to release senior executives to such positions as part of their on-going development programmes to enhance the size of the pool of individuals with the right skills and attributes and also to introduce greater diversity into non-executive directorship appointments. Whilst the appointment of non-executive directors is a matter for the whole board, continued use of nomination committees should be utilised for overseeing the selection, filtering and recommending of candidates to the board. The process for selecting non-executive directors should be formal and transparent and, in our view, much less reliant upon executive search firms.
14. The role of non-executive directors is becoming ever more demanding. Consideration needs to be given to the range of fees paid. These should reflect the time commitment, knowledge and expertise expected of the individual and enable non-executive directors to be appropriately rewarded. In our view, the level of pay of non-executive directors appears not to have kept pace with the increasing levels of personal responsibility and risk involved. Whilst not participating in executive share option plans, non-executive directors should be given the option of being paid in shares or cash or a mixture of both. The payment in shares can assist in the development of a clearer alignment of non-executive directors’ interests with those of shareholders. Shares, in principle, should be retained during the tenure of the directorship. Indeed, we have recently introduced a programme whereby our non-executive directors are able to apply part or whole of their net quarterly fee payments in the acquisition of shares.
15. The Company Law Review’s proposed modifications to s310 Companies Act 1985 are essential. In our experience, recent D&O renewals have seen premium increases of three or four-fold. Policy wording is hardening against the insured. Individuals of the calibre of non-executive directors are very likely to fully understand and appreciate the worsening risk/reward ratio associated with service as a company director. In our view, this trend may represent the most significant single threat to the ability to increase the pool of available non-executive directors in the UK.

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

16. Our recommendation on changes to the definition of an “independent” non-executive director is set out in our response to A above.
17. Board sizes should be commensurate with organisational requirements and should not be prescribed. The most important underlying principle is that whatever the size of the board, the balance between executive and non-executive membership is such as to allow proper debate and determination of matters coming before it, with due regard to the interests of all stakeholders in the company.

18. All companies should demonstrate high standards of corporate governance and operate the various board committees set out in the Combined Code to undertake audit, internal control, remuneration and board recruitment matters in accordance with appropriate terms of reference. Periodically, such as is the current case for audit committees, it will be necessary to review the roles of these important committees but any changes should be the subject of careful consideration and consultation before current requirements are modified.
19. The current composition provisions for such committees appear to us to be appropriate as they allow non-executive directors to perform the required monitoring function.
20. Boards are under an obligation to ensure they operate effectively. Absent a uniform evaluation process, a requirement for external evaluation would be difficult to implement. We recommend further guidance is made available and promulgated to companies before making it a “best practice” requirement for boards to disclose their practice in this area.
21. See above.
22. We believe that non-executive directors are perfectly able to successfully challenge executive decisions and expose serious problems. Care should be taken not to require them to attempt the impossible, such as the detection of a determinedly fraudulent management. Objections can be minuted and ultimately a non-executive director can resign.

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

23. The Combined Code currently provides for the chairmen of various governance committees to be available to respond to shareholder questions at the AGM and it is considered that this requirement does not require strengthening. We see merit in non-executives meeting with institutional shareholders in certain instances. On balance, we believe that the current practice of institutional shareholder meetings being ordinarily undertaken by executive directors and other executive management should continue. We believe that if non-executives were expected as a matter of routine to maintain a dialogue with institutional shareholder representatives they would be constrained in some instances by the fair disclosure rules from entering into any effective two-way dialogue.
- 24-26. The Combined Code currently provides that “all directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with”. In practice, the company secretary is often the

primary point of contact for non-executive directors, frequently with guidance from the Chairman.

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

- 27-30 Guidelines should be put in place by companies concerning the content, presentation and delivery of papers by management to directors for each board meeting, so that directors have enough information to be properly briefed. Conduct of the meeting by the chairman should allow sufficient time for all directors to discuss issues and, where appropriate, to make further enquiries. At the time of a director's appointment, an internal induction programme should be provided on the company's strategic and business plans and developments to date. The content of the induction programme and, where appropriate, any additional training which may be required by the director, should be kept under review. Directors should be advised of their legal and other obligations as a director of a listed company at the time of their appointment and informed of any changes on relevant new laws and regulations and/or changing relevant commercial/organisational/industry risks, as appropriate, during their tenure as a board member.

F Smaller Listed Companies

31. While this Company is a Listed FTSE 100 company and the Paper has been considered in this context, we consider that best corporate governance practices should be applicable to all listed companies, with appropriate non-disclosures given where necessary.

G International Context

- 32-34 Lessons can obviously be learnt from international experiences but any changes need to be carefully considered in the light of domestic prevailing governance codes and regulatory and cultural practices before introducing changes on a reactionary basis.

Combined Code

Certain compliance statements made under the provisions of the Combined Code, which are appended to the UK Listing Authority Rules, are required to be reviewed by the company's auditors before publication. An alternative to making the Combined Code mandatory by making it formally part of the Listing Rules is to extend the review provisions by auditors to include all such statements made by companies under, and in compliance with, the Code.

We hope that our response will prove useful to the review team. Should you wish to discuss any aspect of this letter, please do not hesitate to contact me.

Finally, it is noted that the contents of this response will be regarded as being on the public record and may be disclosed accordingly.

Yours faithfully
For and on behalf of mmO₂ plc

Philip Bramwell
Company Secretary and General Counsel