



## Review of the role and effectiveness of non-executive directors

### Response to Derek Higgs' Consultation Paper

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#### **London**

Hillgate House  
26 Old Bailey, London  
EC4M 7HW  
Telephone +44 207 809 1000  
Facsimile +44 207 809 1005

#### **Silicon Valley**

Suite 100  
200 Page Mill Road, Palo Alto  
CA 94306 USA  
Telephone +1 650 462 4000  
Facsimile +1 650 462 4005

#### **Bristol**

2 Temple Back East  
Temple Quay, Bristol  
BS1 6EG  
Telephone +44 117 917 3000  
Facsimile +44 117 917 3005

#### **Frankfurt**

Fürstenbergerstrasse 3-9  
D-60322 Frankfurt/Main  
Telephone +49 69 9593 2000  
Facsimile +49 69 9593 2005

#### **Thames Valley**

Apex Plaza  
Forbury Road, Reading  
RG1 1AX  
Telephone +44 118 925 2000  
Facsimile +44 118 925 2005

#### **Cologne**

10th & 11th Floor  
Innere Kanalstrasse 15  
D-50823 Köln  
Telephone +49 221 5108 4000  
Facsimile +49 221 5108 4005

## **Foreword by Senior Partner, Osborne Clarke**

Who would be a non-executive director? With critics on every side when things go wrong, and little by way of recognition (monetary or otherwise) when things go right, becoming a non-executive is certainly not the easy option, to be collected like a medal at the end of a distinguished career, that some would have us believe.

Osborne Clarke whole-heartedly supports Derek Higgs' review of the role of non-executive directors, which in the light of recent events in the corporate world is both timely and much needed. The results of our survey, as contained in this report, affirm not only the vital importance of corporate governance generally in the life of our companies, whether large or small, but also the specific part that can be played by non-executives in what Sir Adrian Cadbury famously referred to as "the system of directing and controlling companies".

If there is one quality that stands out to me from this report as being at the core of what it means to be an effective non-executive director, it is independence. As one of our respondents comments, "Independence is a state of mind, incapable of subversion". From it derives the constructive relationships, and sometimes tensions, between executives and non-executives that lie at the heart of any properly functioning board of directors.

We are grateful for the time, thought and enthusiasm which all our respondents have brought to this task. This report is submitted very much on their behalf, in the hope that it will be received as a worthy contribution to this important initiative by Derek Higgs.

A handwritten signature in black ink, appearing to read "Chris Curling". The signature is fluid and cursive, with a prominent initial "C" and a long, sweeping tail.

**Chris Curling**

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## **Introduction: A review of the role and effectiveness of non-executive directors**

This paper is the response of Osborne Clarke to Derek Higgs' consultation paper dated 7 June 2002 ("Consultation Paper") in relation to the role and effectiveness of non-executive directors ("NEDs").

We frequently advise our clients on corporate governance issues and, as a result, we listen to a wide range of views on matters such as the constitution of boards, the different roles of board members, remuneration issues and the decision making process.

The NED is an important element in effective corporate governance and much is expected of the individuals who take up this role. We welcome Derek Higgs' review as an important enquiry at a time when the effectiveness of corporate governance systems are being questioned and new company law in the UK is imminent.

### ***What we did***

Our response represents the views of a selection of our clients and contacts who regularly face corporate governance issues and who have an understanding of how the role of the NED does and should operate in practice.

We approached a large number of individuals, most of whom occupy executive or non-executive directorships on listed company boards, and asked them to complete a questionnaire based around the central themes of the Consultation Paper. The questionnaire asked for brief comments on a wide range of issues. We then interviewed the respondents in order to draw out more detailed feedback on the areas which they considered particularly important.

### ***The results***

The answers to the questions raised in our questionnaire and interviews are presented on the following pages under the five headings of the Consultation Paper. The results presented on the left hand side of the page largely focus on the percentage of respondents who agreed with a particular point.

A number of insightful comments from our respondents on these points are set out on the right hand side of the page. The conclusions at the back of this report are those of Osborne Clarke, deriving not only from the results of this survey, but also our own experience as advisers in corporate governance matters generally.

## Part A: Role

We asked our respondents to help us to define the role of NEDs by identifying the important functions of the role, the main indicators of an independent NED, the necessary time commitment and the duties and responsibilities that the NED should observe.

- All respondents said that there is a requirement for NEDs on the boards of listed companies.
- The respondents as a group rated the following functions of NEDs in the following order of importance:
  1. active involvement in influencing the strategic direction of the business
  2. monitoring the actions of executive directors
  3. representing the views of shareholders
  4. taking responsibility for ensuring independent auditing
  5. acting as a consultant to the board on areas of expertise or industry knowledge
- Many of our respondents considered that balancing the monitoring and strategic roles was difficult but critical to effective performance.
- The respondents were divided equally on the issue of whether it is unreasonable to expect NEDs to observe the same duties and responsibilities as executive directors. Some believe that high levels of NED responsibility are necessary in order to strengthen the role, whereas others consider that the responsibilities and duties should reflect the fact that NEDs devote less time and receive fewer rewards than executive directors.
- 80% said that listed companies should not be allowed to appoint a joint CEO/chairman, although the same percentage of respondents would not object to the CEO moving on to become non-executive chairman of the company provided he was appointed fairly on the merits of his application.

"It is important for the individual to manage the tension between providing hands-on strategic advice and monitoring executive decisions from a detached, independent stance"

"We expect too much from non-executives. The risks attached to the role are so high that the only way it will work is if the rewards are greater"

"If the role of non-execs is to be taken seriously then it needs beefing up. Non-execs need the authority to undertake their duties successfully and the responsibilities (and rewards) should be commensurate, both within the company and at law. To relax the duties of non-execs compared to those of executives would only serve to weaken the role"

"Non-executive directors cannot run companies"

"We expect too much of non-executive directors – companies succeed or fail because of executive decisions"

"If the CEO is appointed chairman at the end of his term, his successor will always find it difficult to run the company"

"The CEO should not be prevented from applying for the role of chairman"

- The lack of independence was a dominant concern of many of our respondents. Only 50% believe that NEDs are sufficiently independent.
- The respondents as a group rated the following indicators of independence in the following order of importance:
  1. no significant financial or personal tie to the company or its management which could interfere with the director's loyalty to shareholders
  2. not receiving an income from the company other than NED fees
  3. no conflicting or cross directorships
  4. not representing significant shareholders or other single interest groups such as creditors
  5. not participating in the company's share option or performance related remuneration schemes
  6. never having been an employee of the company
  7. not serving as a director of the company for more than ten years or being over 70 years of age
- Many respondents also added financial independence to the above list of indicators. It was said that NEDs should have sufficient alternative sources of income not to rely on their fees.
- There was a broad range of opinion on levels of time-commitment and the maximum number of NED posts that may be held by one individual. Some respondents said that a NED should only devote 12-15 days per year to each of a maximum of 3 posts, implying that individuals should not be "serial" or "professional" NEDs. Others said that 30 days work per annum in respect of each of a maximum of 6 posts would be reasonable. In any case, it was generally considered that no more than 6 posts should be held.
- 45% of respondents said that there is no real need for a senior independent director in addition to a non-executive chairman.

"Independence is a state of mind, incapable of subversion"

"To ensure independence, non-executives have to be rich enough not to depend on their fees"

"There are many things that could compromise independence – family ties, masons and other societies, political allegiances – the list could be endless"

"Too many non-execs turn a blind eye to problems – to resolve this, they ought to have sufficient personal investment in the company so that they really care"

On the Statement of Directors' Duties:

- "The private sector is by definition entrepreneurial and opportunistic – its guidance has to be fit for purpose and not hedged in or defended by regulation. The responsibility for sound stewardship, honest dealing and transparency becomes diluted as the volume of words multiplies"
- "If you need to be told what's needed, then you shouldn't be there"

"The number of days per year that should be devoted by a non-exec to his post should not be set in stone – it depends very much on the nature of the company and its condition!"

## Part B: Skills and Recruitment

We asked our respondents about the knowledge, skills and attributes needed to be an effective NED, and what can be done to attract and recruit the best individuals to non-executive directorships.

- The following personal skills and character attributes were stated as being important qualities of an effective NED:

integrity; honesty; ability to listen; facilitating style; ability to negotiate; ability to stand alone; an independent mind; willingness to rock the boat; questioning; diplomatic; intelligent; determined; diligent; analytical; strategic; numerate; self-aware; courageous; a good judgement; a light touch; sense of humour.

- 85% of respondents said that it is preferable for a NED to have previously served or currently be serving as an executive director of another public company.
- The following kinds of experience and skills were considered to be important attributes of an effective NED:

Experience of managing similar sized companies; knowledge of finance, accounting and the law; experience of running other kinds of organisations successfully such as schools, private companies, health authorities and charities; an understanding of how to create shareholder value; experience of the relevant sector in which the company operates; good functional knowledge – strategy, IT, sales, human resources.

- 30% of respondents said that there is an insufficient pool of individuals with the right skills from which to appoint NEDs.
- Some of our respondents suggested that the pool could be widened by recruiting people from outside the business world. Encouraging executives to sit on other boards was also suggested as a way of increasing the talent pool.
- Almost all respondents were happy with the fixed fee approach to NED remuneration, but many felt that the fee should be increased during periods when demands are greater, such as during takeovers and fundraisings.
- Views were divided on the issue of whether NEDs should be allowed to receive shares or share options in the company as part of their remuneration packages. Some respondents felt that NEDs should be rewarded in line with company performance, whereas others that shares and particularly share options could compromise the independence of the NED.

"Non-executives must be capable of stripping away the non-essentials and getting to the nub of the issue"

"Non-execs require an essential blend of intelligence, tenacity and experience"

"It is preferable but not necessary for a NED to have served as an executive director. I do think that governance can be taught"

"Experience on other boards brings broader business experience and helps the individual to be more effective in each post"

"Non-execs can easily be lazy"

"A good non-executive is one who drives for solutions rather than just points out problems, gets down to it rather than skating across the surface, wants the company to do well and is there to help rather than just to perform ceremonial roles"

"A bad one is in the pocket of the executive directors and unable or unwilling to confront"

"Companies should recruit more NEDs from 'outside the box' – particularly to supplement the existing skill/knowledge mix of the board"

"The appointment of specialists to the board is dangerous"

- Our respondents suggested the following ways to encourage individuals to take up NED positions in light of recent corporate failures and the current spotlight on NEDs:

"The company should demonstrate its existing management style, open up information channels and allow the NED to obtain access to reports and personnel, adhere to ethical standards in corporate governance, social and environmental, and facilitate effective shareholder communications"

"Non-execs should be regarded as a special case; they should not be held responsible in the same way as execs in relation to issues regarding the running of the business"

"Give NEDs financial training"

- 60% of respondents said that current pay levels are insufficient to attract the highest calibre individuals to NED posts.
- 65% said that current pay levels encourage serial NEDs to take up too many posts.
- 85% would like to see NEDs dedicating more time to fewer positions and receive higher remuneration accordingly.
- 85% said that "significant effort" goes into appointing a good team of executive and non-executive directors with a broad range of complimentary skills and clearly defined roles.

"I do not like non-execs who have large portfolios that they cannot manage"

"More pay and fewer positions is key to the improvement of the role and effectiveness of non-execs. Why employ a rubber stamp? Non-execs have a greater role to play"

"I agree with fewer positions and more pay, however the interference factor of non-execs is seen as a problem"

"Boards do recognise the importance of an effective team but can be unenlightened in recruiting. It is the 'one of us' syndrome"

"Candidates should meet the whole board before being appointed"

"It is important to recognise that gathering a good team of directors is not a task that can be completed. It is an ongoing process"

"Any experienced CEO and chairman knows that he needs to get the team of directors right for him, otherwise it is Hell!"

## Part C: Structures and Procedures

We asked our respondents whether existing structures and procedures facilitate effective performance by non-executive directors.

- Respondents said that the following provisions of the Combined Code facilitate the effective running of the board and independent decision making:
  - (a) 95% - "Non-executive directors should comprise not less than one third of the board"
  - (b) 85% - "The majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement"
  - (c) 85% - "There should be two key tasks at the top of every public company – the running of the board and the executive responsibility for the running of the company's business"
  - (d) 70% - "There should be a recognised senior member other than the chairman to whom concerns can be conveyed"
  - (e) 95% - "The board should establish an audit committee of at least three directors, all non-executive, with written terms of reference which deal clearly with its authority and duties"
- Our respondents were generally in favour of audit committees consisting exclusively of non-executive directors, but the following suggestions were put forward which may help committees to perform more effectively:
  - (a) the group finance director and other executives should sit "in attendance" as appropriate, in order to answer any queries
  - (b) the chairman of the committee should have a financial qualification
- 30% of respondents said that the processes for setting objectives and reviewing performance against those objectives (for the board as a whole and for individual directors) are not effective.
- 60% said that more could be done to set objectives for NEDs and assess performance against those objectives.

"One should be realistic: dividing power between the CEO and chairman does not prevent insiders from doing the wrong thing if they are determined to do so"

"I reject the notion that a major shareholder is conflicted as a non-exec"

"These provisions of the Combined Code are clearly directed at the largest public companies, and one size doesn't necessarily fit all"

"A senior independent director other than the chairman is not necessary if the chairman is independent and non-exec"

"I disagree with the Combined Code provision that the 'majority' of non-execs should be independent. All non-execs should be independent, otherwise what is the point?"

"An audit committee made up exclusively of non-execs works in practice – it can call to its meetings anybody that it wishes to assist it in making to the board its judgements and recommendations"

"The constitution of audit committees is not as important as the calibre of those who sit on the committees"

"I believe that boards should spend more time on the development and monitoring of assessment processes. The chairman has a key role in this"

- 35% said that board performance is not effectively communicated to shareholders.
- 65% said that there are sufficient procedures available to NEDs through which to challenge executive decisions or expose serious problems.
- 50% said that it should be made easier for NEDs to challenge executive decisions. One respondent suggested that the key to this is ensuring that executive directors provide NEDs with an honest appraisal of issues and the basis for their decisions. Executive directors should be motivated to do this by the value they get from the non-executive challenge.
- It was also suggested that NEDs should get involved early on in the formulation of matter to be considered by the board rather than form an opinion only when the final proposal is presented to the board for approval.
- We asked the respondents to give an example of a situation where a NED had made a valuable contribution to the company. Here are some examples:
  - (a) identifying and challenging an over-optimistic expectation of future performance
  - (b) managing a complete assessment and change of the executive team
  - (c) helping to identify opportunities through sector knowledge
  - (d) resolving a conflict between the CEO and the chairman
  - (f) enhancing the board's understanding of a recently acquired business
  - (g) challenging and ultimately refusing to agree to a proposed form of financial restructuring which was the CEO's "baby"
- 35% of respondents said that it is not sufficiently easy to remove a NED who is not adding value to the board.
- 80% were opposed to strengthening the rights of institutional investors to step in and address poor performance in order to protect their investments (akin to the rights obtained by venture capital houses in relation to the companies they invest in).

"A lot of time can be wasted on assessing the performance of NEDs – it is very difficult to measure"

"It is very difficult to assess NEDs – it involves more qualitative judgements than with execs"

"It could be divisive to distinguish between the appraisal of execs and non-exec"

"The assessment of non-exec should be carried out in one-to-one meetings with the chairman"

"The collective performance of the board is effectively communicated to shareholders, but perhaps not so fully in respect of individual performance"

"A NEDs ability to challenge executive decisions is where education and access to information will pay off"

"My experience is that the chairman does not draw out the different opinions on the board with enough rigour"

"It would be dangerous to give shareholders VC-style rights. VC's have their own short term return needs and exit strategy. They tend to work on the principle of replacing the management team rather than address the more fundamental issues"

- 35% of respondents said that notice periods in directors' service contracts should be reduced depending on the performance of the company during the period of office and the personal culpability of directors for poor performance. Many respondents added that notice periods should not in any case be longer than one year.
- The respondents identified the following lessons in relation to NEDs that can be learnt from recent corporate failures:
  - (a) NEDs can only react to the information provided to them
  - (b) further understanding of financial and accounting issues is required amongst NEDs
  - (c) "friends" should not be appointed to the board
  - (d) share ownership by the board will undoubtedly lead to unwillingness to damage share price
  - (e) if we are to appoint NEDs, then they must have a recognised, serious, properly rewarded and full role to play. They must be totally independent and identified as the guardians of shareholder and stakeholder interests
  - (f) it is essential to have a strong teams of NEDs, led by a chairman who is able to challenge the executive directors

"Shareholders can already bring to bear massive influence on the board. Such a right would be undesirable"

"Shareholders already have such rights – they just don't use them"

"Notice periods should not be longer than one year. The link between pay and performance is not 'rocket science'. A correlation relating poor performance to reduced benefits should be desirable"

"Bad execs are not easy to weed out"

## Part D: Relationships with Shareholders and Others

We asked our respondents whether the relationships between NEDs and shareholders and others needed to be strengthened.

- 80% of respondents said that NEDs are not pro-active in building and maintaining strong relationships with institutional shareholders.
- Although 70% said that NEDs should not be the voice of institutional shareholders on the board, opinion was equally split on the issue of whether the strengthening of the relationship between NEDs and institutional shareholders is key to restoring the confidence of the institutions in the boards of public companies.
- Some of our respondents said that links between NEDs and the institutions should be kept to a minimum (see quotations opposite).
- Problems with company accounting were rated as being more of a militating factor against investor trust in public company boards than excessive remuneration and severance packages which do not match company performance. Other factors identified by the respondents include:
  - (a) lack of transparency
  - (b) annual and interim reporting (quarterly reporting helps)
  - (c) reduction of dividends
  - (d) surprises
- 85% of respondents said that chairmen generally create the necessary environment for effective NED performance.
- In order to create such an environment, the chairman should be doing more to promote constructive relationships, manage the discussion process, encourage challenging and effective contributions at board meetings and ensure that information flows freely to and from the NEDs.
- 45% of respondents said that friendships between executive and non-executive directors restrict the ability of NEDs to act independently.

"The non-exec's role relates, in part, to all shareholders, not simply to major interests. They may represent the voice of the institutions but they are not agents of, nor delegates for, any shareholder"

"The key to restoring the confidence of institutions in plc boards is the strengthening of the role of non-execs, not just the relationship between non-execs and the institutions"

"There is already enough voice from the institutions to the point of 'who is running the company?' "

"Institutions require assurance that the board is effective and all aspects of governance are vigorously pursued. Words will not do this. It is all about confidence in the people"

"The chairman should be approachable and approaching, but more work is needed to ensure true openness and sharing by management"

"Friendships on the board are OK provided they are at an appropriate level"

"The main thing is not to be a friend of the CEO or chairman"

- 35% said that NEDs do not play a sufficient role in monitoring relationships between the board and key advisers to the company.
- Many of our respondents said that the chairman should control the agenda at board meetings, but the executive directors usually produce the board papers.
- 60% said that the company secretary has an important role in supporting NEDs.
- 70% of respondents said that executive directors do not trust the NEDs to communicate with the City in conveying the company message.
- 70% of respondents said that there is currently a balance between non-executive visibility without compromising executive authority. On this issue, one respondent commented that it must be clear who represents the company on particular topics – executive directors on performance and NEDs on conduct.

"Unless care is exercised, friendships can be interpreted as taking sides or for the chairman to be seen as acting through a non-exec in a committee forum"

"Apart from re-appointing the auditors, it is unusual for a board to get involved in the relationships of the executives with third parties"

"The chairman generally sets the agenda, but paperwork is left to the executives and many take advantage"

"The company secretary provides a smooth process and can often help to get a sense of perspective; he is generally seen as neutral"

"The role of the company secretary could be developed further, but great care is needed to ensure that he does not inhibit direct contact with the CEO"

"Communication between NEDs and the City is actively discouraged and I see merit in this discouragement"

"I don't think the City wants to listen to the non-execs that much because they aren't running the company"

## Part E: Support

We asked our respondents how NEDs can best be supported to perform their role.

- 30% of respondents said that NEDs are not given sufficient access to information in order to perform their role effectively. Access to information was considered to be an important issue by many of our respondents (see quotations opposite).
- 30% of respondents said that information flows are not sufficiently open and unrestricted.
- 50% of respondents said that NEDs are not sufficiently encouraged to take advantage of training and development opportunities.
- 70% said that NEDs should undergo an induction or training period at the commencement of a post.
- Lack of information, overbearing directors and a fear of rocking the boat were seen as being the most significant barriers to good NED performance.
- 85% of respondents said that NEDs should be able to obtain independent advice at the expense of the company to help them understand technical issues arising at audit and/or remuneration committee meetings.
- 50% of respondents said that the requirements of NEDs are not sufficiently set out in writing.
- 80% of respondents said that NEDs do not receive sufficient feedback on whether they are meeting expectations.

"The problem with most non-execs is that they do not have enough background knowledge of the business and do not devote sufficient time in order to be fully prepared for meetings"

"Access to information is THE crucial issue – there needs to be much more work in this field"

"A day around the business is generally worth two in the boardroom"

"Non-execs are seen as getting in the way and a danger to existing methods. Non-execs are normally at the mercy of the information provided"

"Very little training actually goes on – it is mostly 'induction' rather than training"

"If a non-executive is doing the job properly, there are no barriers to challenging the executives. In the female gender I have found this to be more the case"

"You are simply expected to do a job of being independent and asking difficult questions"

## Conclusions

Deriving from this report, and our experience of advising boards of companies generally, Osborne Clarke wishes to offer the following headline conclusions:

### ⇒ **The role:**

Primarily, this is viewed as (i) **monitoring** the decision making process, and (ii) influencing the **strategic direction**. However, NEDs cannot be expected to carry out both of these key functions effectively given levels of pay and time commitment, levels of information flow and the processes of boards. The chairman has a key role in **running the board**.

High industry expectations, together with duties which are equal in law to those of executive directors, should be rewarded with **higher pay**. This should be coupled with a requirement to devote more time to each post.

### ⇒ **Skills and recruitment:**

Having necessary **skills** is as important to effective performance as compliance with formal regulatory requirements (e.g. the Combined Code). The key attribute is **independence**, as much the product of experience and personality as compliance with checklist requirements.

The **recruitment pool** is too shallow, and building the board **team** should attract more attention than individual appointments. Current **pay levels** are insufficient, which hampers recruitment. Specific NED **training** is patchy and needs greater resources.

### ⇒ **Structures and procedures:**

The **independence** of NEDs needs affirming and greater definition. The **audit committee** should be comprised wholly of independent NEDs. A **senior independent NED** apart from the chairman has a valid role to play.

Procedures for **access to information** need to be improved, and should allow for NEDs to challenge executive decisions. More could be done in setting and measuring NED **objectives**.

### ⇒ **Relationships with shareholders and others:**

Strengthening the relationship between NEDs and investors is not necessarily appropriate. The **City** and investors generally want to speak to executives i.e. those who run the company. Apart from the auditors, NEDs rarely deal with **key advisers**, but this needs changing. NEDs should avoid forming **friendships** with executives.

### ⇒ **Support:**

Specific NED **training** is patchy and needs greater resources, especially on first appointment. It is vital that NEDs can obtain **independent advice** where necessary at the company's expense. Greater **access to information**, and **knowing the business** on the ground (not just in theory through board papers) is crucial.

## About Osborne Clarke: a leading UK based international law firm

- **Size/locations:** 113 partners and over 900 people based in offices in Bristol, London, Reading, Cologne, Frankfurt and Silicon Valley, California. We also have 9 European offices through the Osborne Clarke Alliance.
- **Business objectives:** to exceed clients' expectations for sound responsive service, professional and commercial judgement and strongly positive relationships; and to provide interesting and rewarding careers for our people.
- **Corporate governance legal expertise:** we have a corporate governance team which draws on a full range of disciplines, including corporate, incentives, pensions and employment, in order to advise our clients. We act as independent adviser to a number of non-executive board committees of major companies. The Sweet & Maxwell publication "A Practical Guide to Corporate Governance" is the product of several of our senior people, including in particular our former Senior Partner, Richard Smerdon. We regularly speak at conferences, and support the training programme of the *nedforum*, formed in 1997 to provide a leading source of professional development for non-executive directors.
- **Reputation:** the key guide to top law firms (The Legal 500, 2001/2002) states "*With its strong brand, international expansion and new Silicon Valley office, Osborne Clarke is forging a reputation for itself as one of the most dynamic and innovative law firms in the UK*". In June 2001 we won the Legal Business 2001 award for "*Most enterprising law firm*". The Lawyer magazine noted that "*Osborne Clarke's management has made it the only regional firm to make serious international expansion; it may even be the only regional firm people forget to call a regional firm.*"
- **Culture:** our culture is something that we are very proud of and careful recruitment has helped to maintain our 'can do' approach. The strength of our management team has created solidarity within the firm that has generated a highly collaborative working atmosphere. The Legal 500 directory states, "*... the firm's ability to attract and keep senior quality lawyers makes it one to watch*". This helps us to guarantee a continuity of service to our clients.

In March of this year we were ranked 56<sup>th</sup> in the Sunday Times list of the 100 Best Places to Work for 2002. This is a distinction that we are very honoured to have achieved and it is a wonderful demonstration of our unique culture.

**Osborne Clarke**  
**October 2002**

Filename: Osborne Clarke.DOC  
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