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Non-Executive Directors Review
Room 2142
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STEERING GROUP
Sir Steve Robson CB
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Response to questions raised in your review

As you know, we have been engaged in consultations on NED/Investor communication, initially involving meetings with over 50 key people including CEOs/CIOs of Investors with over \$2,000bn under management and Chairmen/Immediate Past Chairmen of companies with a combined market value in excess of £250bn, and other leading NEDs such as yourself. We have subsequently extended this dialogue – bringing the total consultees to over 70. Although our work is wholly un-official, and its focus is rather different to yours, we'd be happy to help in any way we can. Here are a few comments on the questions you raise:

A What role should NEDs perform, and how does this compare to the present position?

- **To help boards make better decisions, thus enhancing future cashflows**, both directly and by providing an environment in which staff and shareholders know major decisions will be scrutinised by respected influential independent people.
- **To send appropriate signals to investors** by presence, action and dialogue. The value of such signals is mostly to enhance investors' confidence thus reduce the Risk Premium.
- **To help ensure the integrity of company information.** esp. in the Audit Committee.

In the best run companies these roles are performed well: the challenge is to improve others. We think this is best done by encouraging people from well run companies to serve on other Boards, and by pressure from Investors and peers to raise the quality of NEDs. Significant change to the law would be counterproductive: the problem is not the system but raising levels of performance. Written guidelines will be little help: Enron ticked most of the boxes.

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?

Integrity, and an adequate business and legal understanding, are essential. Not everyone on a Board has to have business experience, but it is very difficult for people to get fully up to speed on complex commercial and shareholder issues if they have not. Diversity is good but tokenism has no place in the stewardship of £bns and the careers of thousands of people.

At present the financial rewards for NEDs are ludicrously low, *both* in relation to the risks they run *and* by comparison with the remuneration of Executives and Consultants. NEDs should be remunerated in a mixture of restricted shares and cash fees, on a scale which makes their effective *per diem* comparable to Executive Directors in other companies of similar market cap¹. We believe Investors would support such increases: very few of *them* are willing to take NED roles on the current Risk/Reward basis.

¹ A specific suggestion from our Report, pp 10-11 is appended. They should not of course have their remuneration linked to the pay of their own Executive Directors nor to those of companies where they have common Board membership. Nor should they be given Options, which create a significant conflict of interest.

Something also needs to be done about the risks NEDs run: NEDs can be personally sued for over £1bn and D&O cover at that level is reportedly unattainable. The sustainability of UK PLC depends on NEDs being willing to perform a quasi-regulatory role and the Government needs to think about how best to deal with this. One possibility would be to cap Directors' liabilities by statute. Another would be to encourage a market-based solution with Insurers providing cover on the scale of the potential liabilities: this would have the advantage that the Insurers would have a strong incentive to encourage good governance².

One important source of talent for NEDs is outstanding executives at, or just below, Main Board level in well-run companies. We are working practically to give this effect: the Chairmen of a number of such FTSE 100 companies have nominated some of their best executives and we are working professionally on finding one suitable NED position for each.

People should be appointed to Boards for their competence, not their status. For example an FC could be a very useful NED on the Audit Committee. Investors would also welcome the professionalism that an HR Director (or similar) could bring as an NED to the Remuneration Committee. The best FCs and HR Directors have good breadth of business judgement, as do the CEOs of major divisions of large PLCs.

C Do existing structures and procedures facilitate effective performance by NEDs?

Yes if used correctly, but often they are not. Innovation and experimentation should be encouraged. One idea that came up in our consultations and attracted wide support was that an NED might occasionally attend a regular company meeting with an Investor.

Cumulatively this would add a great deal to the breadth of understanding by NEDs of Investor issues. However Directors should act in accordance with the Shareholders' *interests* and not necessarily their *wishes*. Shareholders cheered Marconi to the rafters.

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

Informally yes – formally probably not. Shareholders should become a little less shy in providing constructive feedback, and Chairmen a little more ready to listen. We are also surprised by the limited mutual understanding between major Investors and company Chairmen. We are organising some Dinner Discussions to help address this: not focused on particular businesses but on what really happens in Boardrooms and in Investment firms.

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

It is important that NEDs should be well informed on what is going on inside the company – the best companies arrange visits which enable the NEDs to walk around, discuss with plant managers, etc. Boards should get honest feedback on Investor opinion, but not be obsessed by it. NEDs occasionally joining Investor meetings (see C above) could be helpful. The NED role needs to be seen as an important and respected professional commitment, with appropriate induction, training, support (from advisers and the Company Secretary) and proper evaluation of performance *eg* regular 360° appraisal.

We'd be delighted to amplify these points in any way that would be helpful.

With best wishes

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Nicholas Beale

Director

² The risks that the Insurers take could to a large extent be hedged via the derivatives markets: since liability will be limited to (at worst) the market cap of the company. These are not simple issues: having £1bn insurance policies will tend to encourage £1bn claims. Since investors are (in principle) in a worse position to assess the risks than Insurers are, the increase in value of an insured business should in theory be significantly greater than

2.4 NED Remuneration Principles

We believe that there needs to be a concerted effort, preferably led by the Investors, to bring the remuneration of NEDs into the 21st Century. This might build on principles such as the following:

- a. It appears that an NED realistically cannot be on more than 2 major Boards in addition to their 'day job' (and 1 is preferable) and that Non-Executive Chairman counts as half a day job (so a professional NED can chair 2 companies and be an NED on 1-2 more).
- b. The financial rewards of a professional Non-Executive Chairman should be comparable to that of a CEO and those of an 'ordinary' NED should be comparable to those of an ordinary Executive Director.
- c. The interests of NEDs should be entirely aligned with those of the Shareholders. In particular, they should benefit from decisions made – whether about Executive remuneration or other matters – only to the extent that the Shareholders do.

2.5 Suggested Implications

The logic of [c] would suggest that NEDs should be remunerated principally by being given restricted shares at the beginning of their term of office which they have to hold until they leave the Board, and which vest annually. This is logically preferable to Share Options which notoriously mis-align the interests of the option-holders and shareholders if the options are "under water." If the Government is serious about promoting the effective use of NEDs it might be worth considering the tax implications of such arrangements, and ensuring that they are at least as attractive as options.

The logic of [a] and [b] would suggest that, for Directors who undertake to focus their time commitments in this way, an NED's remuneration should be about 1/6th of that of non-CEO Executive Directors in comparable companies and a Non-Executive Chairman's remuneration should be about one third of that of CEOs in comparable companies³. In view of the criticism that NEDs might be implicitly setting their own salaries if they raise the remuneration of the Executive Directors, it might be wiser if these comparables were chosen from samples which excluded the company itself (eg the 20 companies nearest the company in question in market cap. on which none of the present Board served).

To avoid hardship - and to avoid discouraging the emergence of the younger professional NED, it might be worth allowing fees of up to the currently prevailing levels to be taken in cash at the option of the Director. But we believe that a share-based remuneration scheme such as the one described provides the appropriate alignment of NED's and Shareholders' interests.

A serving CEO shouldn't be on more than 1 [other] board

NEDs shouldn't do more than 3 or 4 Directorships.

An individual once told me very proudly that he had 10 NEDships. This is ludicrous. 4 or 5 is about right.

Even holding 2 NEDships could be a problem, given that every year ¼ of the FTSE 100 is in serious difficulty

In looking at our problem of trying to establish Corporate Governance that's applicable across different boundaries, the question arose of how many NEDships you can legitimately hold. In the UK this was felt to be 3, in France 5.

When I was Chairman at [X], I allowed my Main Board colleagues to have 1 NEDship, and in exceptional circumstances 2. At [Y] I'm part time Chairman, I also Chair [Z], and spend a day and a bit a week on W plc. I'm not in favour of those who take half a dozen NEDships; you have to spend time in the Company to do the job properly.

Source: interviews with Investors & NEDs

the premiums, and hence the result should be value-creating. *We should stress that, although the issue of Risk has been raised heavily in our consultations, these insurance-based proposals are Sciteb's alone.*

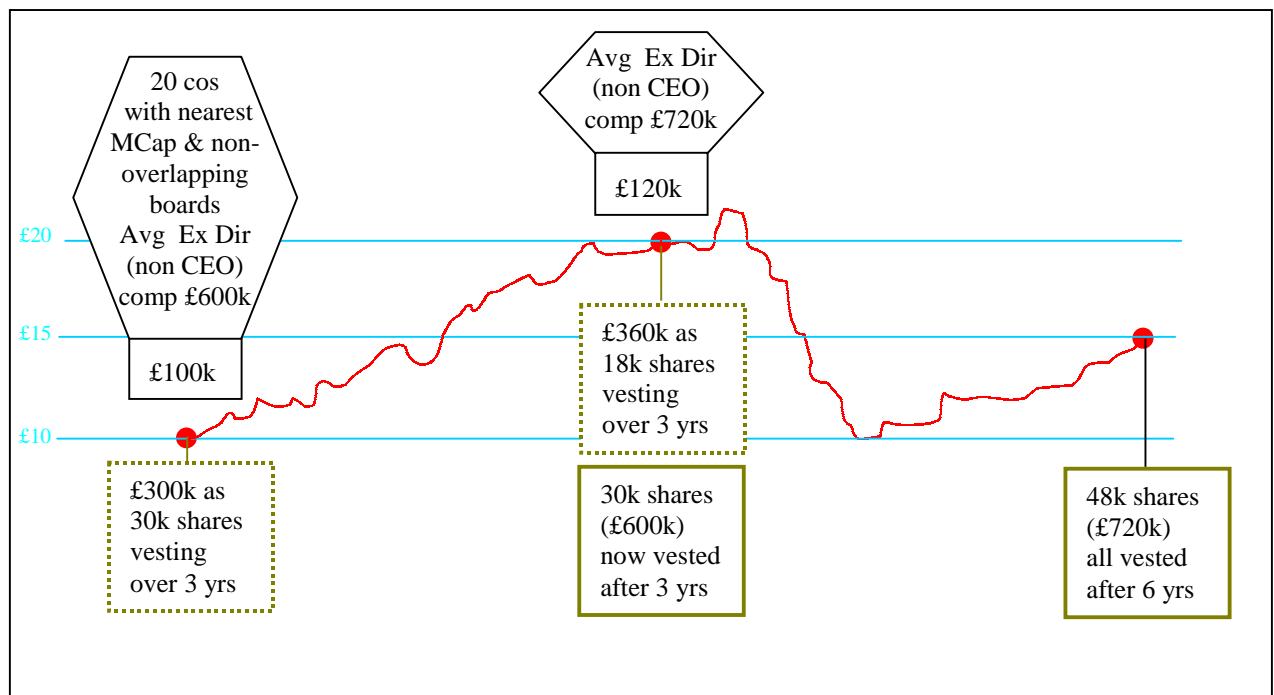
³ Interestingly, in the US company mentioned above, the CFO has a \$700k in salary. It is hard to find details on Bonus, Pension and Option arrangements (the schemes are described in detail but the amounts, other than a maximum bonus of \$3M, are not so transparent), but it seems reasonable to assume that they might amount to \$500-700k

Hypothetical Example

X plc, a well regarded company in the middle of the FTSE 100, wishes to appoint “Chris” as an NED initially for a 3 year term. Of the 20 companies nearest to it in market cap, 2 have common directors – so they are excluded and the 21st and 22nd nearest are added to the comparator sample. The Executive Directors received total remuneration (salary, bonus, options) in the last year for which Annual Reports were available of, on average £600k – so a fair remuneration is set at £100k pa. X’s shares trade at £10 so “Chris” is remunerated with 30,000 shares of which 10,000 will vest in each of the 3 years. Over these 3 years X’s shareprice grows to £20 and so Chris ends up with £600k worth of shares.

Signing up for a further 3 year term, it is found that average comparables remuneration is £720k, so a fair remuneration is set at £120k and Chris is given a further 18,000 shares, vesting at 6,000 shares per year. Unfortunately the share price falls one year later (*ie* Year 5) back to £10. Chris and the rest of the Board focus hard on restoring and enhancing the underlying value of the business: they have a lot to gain (Chris’ holding is now valued at £480k of which all but £60k is vested) but they have no incentive to try desperate measures. In particular they reject an ambitious share-buyback plan which would have geared up the equity and, in Chris’ judgement, been roughly as likely to nearly double the shareprice as to render the shares nearly valueless⁴. Investors regain confidence and at the end of Year 6 the shares recover to £15. Chris’ overall remuneration has been £720k or about £100k pa allowing for interest costs.

Chris reflects with satisfaction that at least the investors knew that the Board had no incentive other than sustainable growth of shareholder value – with no incentive for unrealistic hype or for excessive risks. Indeed she would have been a bit better off if the shares had reached £12, and not £20, at the end of Year 3 – but so of course would any shareholders who had invested a given sum each year into X’s shares.



⁴ Such a scheme would be attractive to options holders whose options are substantially under water, since they have nothing to lose by a further substantial reduction in the shareprice – and something to gain by sheer volatility.