

SCOTTISH & NEWCASTLE PLC

Review of the Role and effectiveness of Non-executive Directors

1. Introduction

This note sets out the views of Scottish & Newcastle plc on the consultation paper published by Derek Higgs on 7 June 2002. We comment on the main areas covered but have not sought to comment on each individual numbered question although they have provided a background to our comments.

2. Summary of views

In summary, our views are:

- (a) Non-executive Directors should be regarded as members of a cohesive board team, with both a leadership and a monitoring role. For the vast majority of companies the existing unitary board structure is the right one; we would resist any suggestion that Non-executives should be divided between those who lead and those who monitor.
- (b) We see the current system working well and that there is a danger of overprescription by detailed rules. More emphasis should be laid on the role of the Chairman, who should be given clearly recognised responsibility to achieve a Board which has the right overall balance of qualities and experience, and operates in an independent way.
- (c) Best practice recommendations in some functional areas could be helpful, in particular:
 - terms of reference for Committees;
 - supply of information and access to management; and
 - induction, training and development.

3. Our response to the issues raised

A: Role

What role should Non-executive Directors perform, and how does this compare to the present position?

Scottish & Newcastle broadly agrees with the role of the Board recognised in the Combined Code, which is to “lead and control” the Company. This role recognises two elements. First, that the Board should lead the strategic direction of the Company and secondly that it should ensure that appropriate controls are in place so that the Company can conduct its operations effectively. Although individual Directors may have specific functions, each Director should be responsible for both the leadership and control elements with no particular distinction between Executive and Non-executive Directors. Hence, we agree with the observations of the Hampel Review that “Non-executive Directors should have both a strategic and a monitoring function”. We also agree with the observation that Non-executives and Executives should work together in a cohesive team so that individual Non-executive Directors can contribute different skills and experience to that team.

In some cases, Non-executives will perform a role which would not be appropriate for Executives. These roles include: setting the remuneration policy for Executive Directors (and, effectively, for other executive management) through the Remuneration Committee; ensuring that proper controls are in place throughout the Group (through the Audit Committee) and contributing to succession planning (through the Nominations Committee).

Whilst Non-executives should not necessarily be expected to fulfil all these roles at the same time (that is, by being members of all three Committees), all Non-executives should have sufficient experience and judgmental width, so that they are capable of fulfilling each of these roles as and when required.

We believe that all Directors should have strong features of independence, but this should be judged on a positive basis because of their experience, reputation and intellectual approach. The characterisation of non-independence by an escalating list of exclusions for peripheral factors would not produce better Directors or a better Board. Positive qualities are much more important, such as successful past experience, a reputation which is on the line and freedom from financial dependence on the fee being paid. Declaration of conflicts is a well established convention and is better than automatic general disqualification.

The main potential areas of conflict which may arise at Board level relate to Board remuneration, audit supervision, and, possibly, strategic decisions, such as major acquisitions or a response to a take-over approach. Non-executive Directors have a particular role to play here, and the two best of ways of ensuring that Non-executives can carry out this role effectively are first, to ensure that they have the necessary business experience to face such issues and secondly, that they have access to the Company's advisers. It is important that Non-executives should have full confidence in advisers and we would expect them to be involved in the decision appointing or changing key advisers.

We suspect that the time commitment for Non-executives varies considerably between companies. In our own case, we have seven regular Board meetings throughout the year together with, say, three regular meetings of each of the Remuneration, Audit and Treasury Committees. Further ad-hoc meetings including meetings of the Nominations Committee are invariably necessary, to consider such issues as remuneration policy and acquisitions. In addition to these meetings, there is background reading and Committee Chairmen usually meet regularly with Executives. In practice, therefore, the time commitment can vary between the equivalent of, say, ten to twenty full days each year. We currently have a full-time Chairman; where a Chairman is Non-executive we would expect his commitment to be in the order of one to two days per week and greater should the particular circumstances require. It is not practicable to stipulate a maximum number of other Non-executive (or Executive) posts for Non-executives: what matters is the skills they bring to the Board and their availability, whether on a routine basis or in the event of a particular issue arising. Again, this is a judgement for the Chairman.

Where the Chairman is full-time, we believe that there is a useful role for a "senior independent" Non-executive Director who can be seen as essentially entirely independent from the Executive team. Where the Chairman himself is an independent Non-executive, we would question the need for a separate designated Director.

Given the advantages of a unitary Board and a coherent Board team, it would not be appropriate to distinguish between the legal duties of Executive and Non-executive Directors. We would strongly resist any suggestion that Non-executive Directors themselves should be categorised into those with a strategic or business role and those with a monitoring role.

Finally, as a general observation on this section, we firmly believe that the role of the Non-executive Director should not be considered in isolation from other corporate governance issues. We would not wish to see any separate regulation of Non-executive Directors which did not reflect other corporate governance mechanisms – any new proposals should ideally be reflected in the Combined Code.

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 Non-executive roles?

Scottish & Newcastle's principal business is the production and distribution of beer internationally. In addition, we distribute other beverages in the UK and overseas and own and operate pubs and budget hotels in the UK. Diversity of experience is crucial to both the leadership and control roles and Non-executives should have the skills, knowledge and experience which are relevant for our businesses. Hence our own Non-executives have backgrounds ranging from international manufacturing, the production and distribution of beverages and food and finance. In particular, they bring expertise in areas such as marketing, branding, intellectual property, corporate finance, managing a multi-national business and specific country expertise.

We have not, so far, experienced any particular difficulties in recruiting Non-executive Directors although inevitably, given the current climate and our basic criteria for appointment, the pool of potential Non-executive Directors is not unlimited. We are concerned that a further excess of prescriptive rules governing Non-executives will discourage the best talent and diminish the pool to disconnected, relatively inexperienced and lower quality representatives. As our business becomes more international, we would expect greater international representation on the Board. Already, one half of our Non-executive Directors are non-UK nationals.

We set our Non-executive fees in line with market practice although, in line with the market, they could be said to be proportionately low when compared with what an Executive Director would be paid in a Company of comparable size. Whilst we believe that this has not, to date, acted as a constraint in recruiting the best calibre candidates, if the commitment or responsibilities of Non-executives continues to increase (whether as a result of external regulation or our own requirements) we believe that the level of fees would have to be increased substantially in order to reflect the greater commitment.

C: Structures and accountability

Do existing structures and procedures facilitate effective performance by Non-executive Directors?

Scottish & Newcastle complies fully with the Combined Code and we have experienced no major difficulties in its working in practice. We agree with the provisions on the balance between Executive and Non-executive Directors and with the roles of independent Non-executive Directors. We believe that the characteristics of independence are for each Board to define as an aggregate quality of the Board, rather than by a process of exclusion. The Chairman has a key role in monitoring overall balance of independence in a Board and how it operates.

Within our Group, we believe that the Board Committees work well in practice. Whilst we do not think it strictly necessary for the Combined Code to specify precise terms of reference for committees, we see some merit in including outline terms of reference in order to identify best practice. Given, however, that the internal operations of the Board are ultimately the matter for the Board itself, these should be included by way of guidance only. We have recently conducted a review of Board processes through our own internal audit function, involving all Directors. As a result, we are implementing a number of changes to the way the Board operates. We do not, however, see these as a matter for inclusion in the Report to shareholders. Moreover, we do not see how Board performance can qualitatively be reported to shareholders; simple attendance at Board meetings, for example, would give little indication of the actual contribution made by an individual Director.

If Non-executive Directors are successfully to challenge decisions or expose problems, they need adequate information (as to which see part E below). If Non-executive Directors are concerned about particular issues then the first step should be to seek to resolve the issue through raising it within the Board itself. If a Director or group of Directors are not satisfied with the result, the next step would be to take independent professional advice as they are entitled to do under the Combined Code. We do not think it practicable to specify what, if any, further action might be appropriate – it would depend upon the circumstances and the advice received.

D: Relationships with shareholders and others

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

We have not experienced any major difficulties concerning relations between Non-executive Directors and shareholders or other stakeholders. Non-executive Directors are available at our Annual General Meeting to answer any questions relevant to their particular role and, in special circumstances, there is no reason why an institutional shareholder should not be able to approach the senior independent Non-executive Director or the Chairman of a Committee to raise particular concerns. However, the proper channel of communication between institutional shareholders and the Company should be through specifically designated Executive Directors or spokesmen; only they can expect to be briefed to an appropriate level of detail. We do not think that much would be achieved by having Non-executive Directors present at such meetings as a matter of routine. Some contact may be appropriate in exceptional circumstances.

We believe in a culture of openness and encourage interaction between Non-executives and others where appropriate (for example the Chairman of the Audit Committee meets regularly with the Auditors and the Group Finance Director). The Chairman regularly meets Non-executive Directors informally. Normally access to Executives below Board level should be through the Company Secretary or appropriate Executive Director.

E: Support

How can Non-executive Directors best be supported to perform their role?

Non-executive Directors should be given sufficient information to enable them to perform their role effectively. We see information falling into two categories. First, there should be a regular flow of information given to Directors. In our own case, we circulate comprehensive management reports to all Directors each month covering all strategic, financial and operational aspects of the business. We suspect that we give Directors a greater degree of regular information than many other companies, although we think that the precise level of information is a matter for each company to decide. Secondly, Non-executives may require access to further information. We would expect such requests to be raised at Board meetings or through the Company Secretary or an Executive Director – i.e. there should be a proper channel of communication allowing Directors to obtain a further level of information where appropriate.

Scottish & Newcastle runs an induction programme for all new Directors, whether Executive or Non-executive, which is tailored to meet the requirements of the Director in question. All Directors are also kept abreast with developments effecting the industry or companies in general, whether by the regular management reports or special papers discussed at Board meetings. Whilst it is clearly important for all companies to have induction, training and development programmes in place, we think the detail of such programmes is a matter for the Company concerned. However, it might be helpful for the Combined Code to include some guidelines as to best practice in this area.

It is the role of the Chairman to ensure that Directors are given clear guidance on what is expected of them and to receive appropriate feedback. We do not think that this necessarily has to be done in any formal evaluation process; informal feedback may be just as appropriate. Again, we see this as a matter for the individual Company concerned.

F: Smaller Listed Companies

In what ways is the position different for smaller listed companies?

We have not sought to comment on this issue.

G: International Context

What can we learn from international experience?

In general, we believe that the UK model of corporate governance for listed companies works well. We do not see that other models have clear advantages over the UK's combination of a unitary Board, comprising Executive and Non-Executive Directors and the operation of the Combined Code. However, as our Company continues to expand overseas, we foresee that our own governance processes will evolve in order to reflect the expectations of shareholders, employees and business partners in other countries. The relatively flexible model that we have at present should provide a sound base for any such adaptation. Whilst, as we have indicated above, we can see merit in some further guidance of best practice being included in the Combined Code, we would not wish to see the introduction of any new regulation which would inhibit our Board's ability to lead and control the Group as it develops internationally.

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