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USS

UNIVERSITIES
SUPERANNUATION
SCHEME LIMITED

Mr Derek Higgs
Non-Executive Directors Review
Room 2142
1 Victoria Street
London SW1H 0ET

Date: 11 September 2002

Dear Mr Higgs

I am writing to you on behalf of the Universities Superannuation Scheme Ltd, one of the UK's largest private sector pension funds, with assets of £18 billion.

USS Ltd welcomes the opportunity to respond to your consultation document and has focussed its response on the 'human side' of corporate governance which we believe the review needs to address if the quality, performance and effectiveness of non-executive directors in the UK is to be improved. In this submission we take the view that all non-executive directors should be independent, and therefore use these terms interchangeably. This is because we see, in general, little value in appointing a director who is not independent to a non-executive position.

As an institutional shareholder who takes seriously its responsibility to be an active owner, USS Ltd is concerned with the quality and effectiveness of *all* the agents running the companies in which we invest. Of particular importance and interest to USS Ltd is the contingent of independent directors whom have primary responsibility for representing, safeguarding and protecting our interests as investors and providing the appropriate checks and balances in the boardroom.

However, it is important that the review does not look at the independent directors in isolation from the framework in which they operate but also looks at ways of maximising the effectiveness and performance of the board as a whole. Indeed, the goal of well-functioning boards should be to work together to shape the destiny of the company, safeguard its interests and ensure its profitable performance. From our perspective, therefore, the importance of your review, and its focus on independent directors, is that it could play an important role in realising the untapped value of boards, both in terms of optimising rewards and reducing risks for shareholders and also other stakeholders.



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Although corporate governance standards have improved significantly over the last decade, there is still much room for improvement. Indeed, USS Ltd is cautious of being overly reliant upon compliance with the combined code as an adequate indicator of good corporate governance practice. USS Ltd is now looking for more informative and qualitative measures of board composition and performance to be used to evaluate board effectiveness. In addition to having the right systems in place, USS Ltd believes very strongly in encouraging boards to become more dynamic and diverse. A board's composition, structure and processes should therefore be able to adapt and re-adjust to match the changing and increasingly demanding expectations being placed upon them.

For these reasons, USS Ltd has decided to focus its submission on the key components which relate to the more 'human side' of corporate governance. Our recommendations to the review, which are discussed in more detail in the attached document, include:

1. Improving the selection and appointment process of independent directors by:
 - Developing the professionalism of the nominations committee;
 - Limiting the number of positions independent directors take on;
 - Casting the net more widely when recruiting independent directors.

2. Improving board performance by:
 - Encouraging regular evaluations of the composition and performance of the board as a whole and the performance of each director individually, and to take the appropriate action;
 - Ensuring all newly appointed independent directors undergo an induction process and subsequently undertake continuing professional development;
 - Providing all newly appointed independent directors with specific guidance notes (from Companies House) which should be signed as a declaration of acceptance of terms and conditions of appointment.

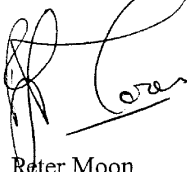
3. Improving disclosure by:
 - Providing more information on the appointment process;
 - Disclosing more information on the training provision for independent directors;
 - Reporting to shareholders on the evaluation process and its outcome

Mr Derek Higgs

11 September 2002

I hope that you find our submission persuasive and are able to respond positively to these recommendations. If you wish to discuss any of these issues further, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Peter Moon', written over a horizontal line.

Peter Moon
Chief Investment Officer

Improving the selection and appointment of independent directors

As institutional shareholders, we have very little influence over the selection and appointment of independent directors to the boards of companies in which we invest. We are able to vote against new appointments to the board when directors stand for election at the AGM following their appointment, by which time they are already in place, and vote against re-appointments when independent directors are up for re-election. As we are, therefore, not directly involved in the process of recruiting and appointing directors, shareholders need to have confidence in the board and the nominations committee (where it exists) to do the job on our behalf, in a thorough, methodical and impartial manner.

A scan of annual reports suggests that few boards pay sufficient attention to the structure and processes of their nominations committee. Although the majority of UK companies are fully compliant with the combined code recommendation of having a nominations committee in place, it would appear that in many cases they meet infrequently¹ and have a rather superficial, informal and non-transparent selection and appointment process for non-executive directors. USS Ltd looks to the nominations committee to oversee the process by which directors are nominated, to select the candidates to be nominated, and to recommend policies and procedures regarding board structure and processes. Nominations committees should have a majority of independent directors and should be chaired by the chairman of the board or an independent director. Despite its vital role, research suggests that the nominations committee is perhaps the least well-run and least professional of board sub-committees.

USS Ltd agrees with the conference board's position² that boards should not reinstate directors automatically, as the nominating process should be viewed as a continuing opportunity to evaluate the strategic composition of the board. USS Ltd therefore encourages a continual evaluation of the core competencies that the board needs to function at optimum level (see below). This should be led by the chairman whose team selection process and leadership skills will be crucial in maximising the board's effectiveness.

The process for recruiting independent directors must be as sophisticated, thorough and methodical as the recruitment process for executive directors. The starting point must not be the person but the tasks to be performed having identified the gaps in experience, background, age, knowledge and balance of skill-sets around the boardroom. The selection of new directors should involve consideration of the individual's potential contribution to the board such as expertise in remuneration issues.

The nominations committee, often working with search and selection consultants, must also ensure that potential candidates have sufficient time to devote to the company and are not overstretched with other commitments. In particular, they should be sufficiently confident that in an event of a boardroom crisis or if the company starts performing badly, the non-executive director candidate would be able to cope with the unexpected demands placed upon them. USS Ltd is

¹ According to recent research by KPMG, the majority of UK nomination committees have less than two meetings per annum (*Corporate Governance in Europe*, KPMG survey 2001/02)

² L. Alexander, *Determining Board Effectiveness: A Handbook for Directors and Officers*, Conference Board, 1999

supportive of NAPF's recommendation that a full-time executive should not normally take on more than one outside directorship and if he/she holds purely non-executive positions to justify how they can manage more than five posts (including the boards of charities etc).

USS Ltd recognises that unless the pool of talent is expanded, it will become increasingly difficult to find people of a suitable calibre who are willing to become independent directors. We therefore believe that nominations committee should encourage their headhunters to cast the net more widely when recruiting new independent directors. This could include other potential pools of talent, which are usually overlooked, such as the civil service, academia and senior management of large companies.

Improving board performance and evaluation

According to a recent Egon Zehnder survey, only a quarter of UK companies have formal appraisal processes which typically take place once a year. There is little indication that this will change as 85% of companies who responded to the survey stated that they had no plans to instigate formal appraisals in the future.³

The evaluation of the mix and performance of independent directors is, in our experience, even more of a rarity in UK boardrooms. USS Ltd seeks to encourage boards of companies to undergo a regular evaluation of each director and the board, as a whole to ensure the board remains effective. USS Ltd believes that appraisals should be a prerequisite for the appointment, induction, on-going training or removal of independent directors.

The process should be overseen by the chairman and the nominations committee and should be used, inter alia, to:

- ensure there is an appropriate balance of skill-sets and experience on the board;
- identify skill shortages on the board;
- assess each director's contribution;
- manage the succession planning process;
- ensure that non-executive directors are genuinely independent;
- ensure that directors are not over-stretched with other external commitments;
- ensure the board composition matches the needs of the business.

Induction and training of independent directors

This component of improving board performance is, we believe, worthy of particular mention. USS Ltd fully supports the combined code's recommendation that all directors should receive appropriate training on the first occasion they are appointed to a listed company and subsequently as necessary. Such training, in our opinion, is appropriate both for executive and independent directors to ensure that they fully understand the role and responsibilities of a board

³ K. Bingham, 'Defining Board Effectiveness', *Chartered Secretary*, July 2001

director. However, recent research suggests that such induction and training is not prevalent in UK boardrooms, particularly among independent directors.⁴

USS Ltd believes that all newly appointed independent directors should undergo an induction process which should include meetings with key members of the executive team and visits to the company's main operating sites. USS Ltd would also like to see non-executive directors appointed for the first time receive specific guidance notes on their duties, responsibilities and liabilities from companies house. Recipients of this guidance should be required to sign a form declaring acceptance of the terms and conditions of their appointment as non-executive directors.

In addition, USS Ltd would like the government to encourage newly appointed independent directors of listed companies to participate in director training courses. In Hong Kong, for example, the Hong Kong Securities Institute is developing a two-day course in association with regulatory bodies which new recruits will be strongly encouraged to attend.

There is a strong argument that the board and its members should be seen as a learning organisation in a state of continuous change and development. Indeed, if individual directors and the boards on which they serve are to be dynamic, so that their company prospers and grows, time must be set aside for the personal development of each director and of the board as a whole. For example, specific training will be required for independent directors on remuneration and audit committees to remain informed of best practice. Similarly all directors, executive and independent, will need to have an understanding of, and be able to respond to, "non-financial risks" - a relatively new concept for some directors and an increasingly important one given the growing importance of corporate governance and corporate social responsive performance. USS Ltd is therefore fully supportive of initiatives such as the Institute of Director's 'Chartered Director' professional qualification, which aims to set a benchmark for directors, including non-executive directors, and to raise their professional standards.

Improving disclosure

As explained above, USS Ltd considers the process by which independent directors are selected, recruited and appointed to the board to be of paramount importance and a key factor in determining the board's effectiveness. However, a cursory study of recent annual reports suggests that the majority of companies provide little information on the non-executive (and indeed executive) director appointment process. Furthermore, few details are disclosed on their nominations committees' terms of reference, activities and processes in comparison with the audit and remuneration committees. USS Ltd believes that this imbalance should be redressed with more information provided on:

- Terms of reference for independent directors;
- Specific experience of qualities of the independent directors;
- Briefs given to the search firm and details of consultants used;

⁴ See, for example, the Beaufort report (1996), the IoD's survey 'Sign of the Times' (1998) and the IoD/Ernst & Young's *Independent Director* survey (1999).

- Induction programmes for independent directors;
- Continuing professional development (e.g. courses and seminars that directors attend);
- The process the board uses to evaluate its own performance and that of individual directors.

Thus USS Ltd would like see this Review take actions which result in boards disclosing more information on the appraisal process and its results. For example, in the 1990s the US company Campbell Soup devised a detailed appraisal mechanism and each year it reports back to its shareholders the results of the exercise, outlining the perceived strengths and weaknesses, along with any corrective action to be taken.

USS Ltd was disappointed that the Company Law Review Steering Group did not proceed with its original suggestion to introduce "a more explicit requirement" for boards "to disclose information about relevant training and experience before election of directors to office." USS Ltd hopes that this Review will correct this omission and address the issue of disclosure of information on training provision.