January 20, 2003

Corporate Governance - The Higgs Report

After a nine-month gestation, the report by Derek Higgs, commissioned by the UK Department of Trade and Industry, on the role of independent directors, was published in London this morning. As one would expect from Derek Higgs, it is a tour de force — well written, well organized, carefully considered and forcefully presented. All in all a major addition not just to the Cadbury, Greenbury and Hampel Reports, which preceded it, but to the Anglo-American reports and literature on corporate governance of the past decade. It is recommended reading for all those who are interested in corporate governance. It is available at *www.dti.gov.uk/cld/non_exec_review*.

Key recommendations of the Higgs Report, in large measure in the words of the report, are:

1. While a majority of the board should be independent, non-executive directors, there should be a strong executive representation on the board.

2. The roles of the chairman and chief executive should be separated and the division of responsibilities should be established by the board. The chairman is responsible for:

   (a) leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda;

   (b) ensuring the provision of accurate, timely and clear information to directors;

   (c) ensuring effective communication with shareholders;

   (d) arranging the regular evaluation of the performance of the board, its committees and individual directors; and

   (e) facilitating the effective contribution of non-executive directors and ensuring constructive relations between executive and non-executive directors.

3. A chief executive should not become chairman of the same company and at the time of appointment should meet the test for an independent director.

4. A non-executive director is considered independent when the board determines that the director is independent in character and judgement and there are no relationships or circumstances which could affect, or appear to affect, the director’s judgment. Such relationships or circumstances would include where the director:

(a) is a former employee of the company or group until five years after employment (or any other material connection) has ended;

(b) has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;

(c) has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or performance-related pay scheme, or is a member of the company's pension scheme;

(d) has close family ties with any of the company's advisers, directors or senior employees;

(e) holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;

(f) represents a significant shareholder; or

(g) has served on the board for more than ten years.

The board should identify in its annual report the non-executive directors it determines to be independent. The board should state its reasons if a director is considered to be independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination.

5. The non-executive directors should meet as a group at least once a year without the chairman or executive directors and the annual report should include a statement on whether the meeting occurred.

6. A senior independent director should be identified as available to shareholders, if they have concerns that have not been resolved through the normal channels of contact with the chairman or chief executive. The senior independent director should attend a sufficient number of the regular meetings of management with a range of major shareholders to develop a balanced understanding of the themes, issues and concerns of shareholders. The senior independent director should communicate these views to the non-executive directors and, as appropriate, to the board as a whole.

7. Chairmen and chief executives should implement executive development programs to train and develop suitable employees for future director roles.

8. There should be an annual evaluation of the board, its committees and the individual directors. The annual report should state whether such evaluations are taking place and how they are conducted.

9. A non-executive director should normally be expected to serve not more than two three-year terms, with limited exceptions.

10. A full-time executive should not be a non-executive director of more than one outside company.

11. The remuneration of a non-executive director should be sufficient to attract and fairly compensate high quality individuals. It may include shares, but not options.

12. The board should establish an audit committee of at least three members, who should all be independent non-executive directors. At least one member of the audit committee should have significant, recent and relevant financial experience. The Higgs Report refers to the Smith Report on Audit Committees, also published today, with respect to the purpose, procedures and duties of the Audit Committee.

The Smith Report provides that the main role and responsibilities of the Audit Committee should be set out in written terms of reference and should include:

(a) to monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgements contained in them;

(b) to review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems;

(c) to monitor and review the effectiveness of the company's internal audit function;

(d) to make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor;

(e) to monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant UK professional and regulatory requirements; and

(f) to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm.

The audit committee should be provided with sufficient resources to undertake its duties.

The annual report should contain a separate section that describes the role and responsibilities of the committee and the actions taken by the committee to discharge those responsibilities.

13. The Higgs Report describes the role of the board as: The board is collectively responsible for promoting the success of the company by directing and supervising the company's affairs; the board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed; the board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives, and review management performance; the board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

* * *

Except for the requirement of separation of the roles of chief executive and chairman, the provision for strong executive representation of the board, the limit on number of board memberships, the limit to two three-year terms as a non-executive director, and the meetings of non-executive directors with shareholders, the Report in large measure parallels the NYSE corporate governance proposals made by the Committee on Corporate Accountability and Listing Standards last year, which are currently awaiting approval by the SEC.

The Higgs Report will lend some weight to the Conference Board and other recommendations in the US to separate the roles of chief executive and chairman. I continue to believe this is not desirable and that the NYSE proposal for regular meetings of the non-executive directors with an identified non-executive director chairing such meetings accomplishes the fundamental objectives of the separation of roles and the facilitation of liaison with shareholders.

M. Lipton