
Introduction

The Institute of Directors (IoD) welcomes the opportunity to respond to the Review, not because we feel there is a crisis in UK governance but because we believe that standards in the boardroom can and should be improved, and that the role of the non-executive director is crucial to this.

Our concern is not only for probity but for general board-level performance. Shareholders, as well as other stakeholders, are at far greater risk from a mismanaged or underperforming business than they are from wilful wrongdoing.

The IoD's response is set out in the following pages, and follows the format of the consultative document.

It has been shaped by seven main inputs:

- The work of our Professional Standards Unit
- The work of our Policy Unit
- Lessons gleaned from our Director Development courses
- The experience gained with our Chartered Director Programme (the world's first formally accredited director qualification)
- The work of the Independent Director initiative that we have operated jointly with Ernst & Young for the past two years
- Specially convened focus groups drawn from both large and small companies
- A survey of 125 widely experienced directors, selected to embrace leaders of major companies, leading entrepreneurs and board members specialising in smaller companies.

A: Role

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

1. *What is the role of the board? What is the role of the Chairman and how does it relate to the non-executive director?*

In 1999, the Institute of Directors defined the key purpose of the board as:

“To ensure the company’s prosperity by collectively directing the company’s affairs, whilst meeting the appropriate interests of its shareholders and relevant stakeholders”.

Interestingly, there are no express requirements in law as to the nature or functioning of a board of directors. However, it has become the main entity for directing companies and the basis for corporate governance. The Articles of most companies state that the business of the company will be managed by the directors, who may exercise all such powers of the company. Executive powers are therefore vested in the board as a whole.

Since non-executives participate equally in all the executive decisions taken by the board the term ‘non-executive director’ may seem like an oxymoron.

In practice, the board delegates executive authority to the executive directors, especially the chief executive who heads the management team. This does not, however, absolve the board of responsibility for the company’s affairs. Authority can be delegated, but not responsibility. Ultimately the board exercises whatever executive power that it needs to take.

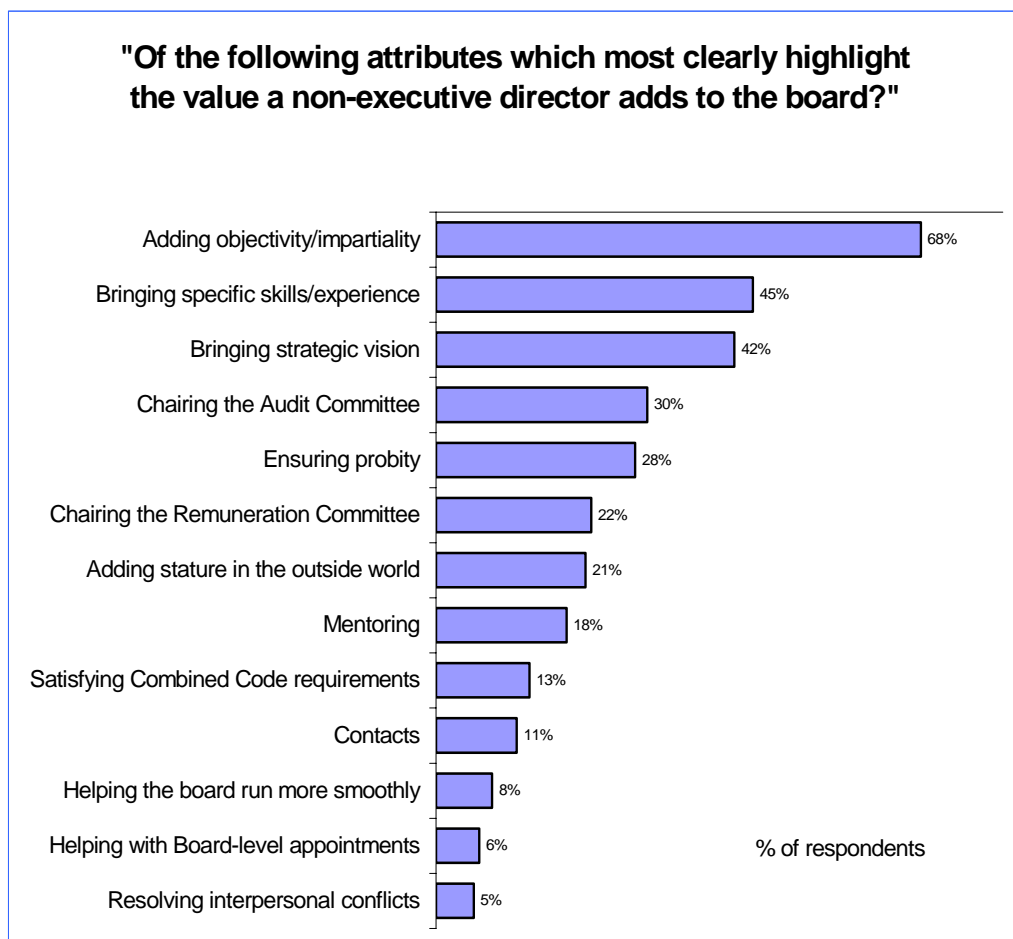
Of significance too, the role of the chairman is not defined in law. There is nothing in the Companies Act that requires such an appointment, although in practice every company has one. Although often referred to as the ‘chairman of the company’, the role is actually that of chairman of the board of directors, who under the company’s Articles also acts as chairman of any general meeting of the shareholders.

This means there is a great deal of latitude in the way the role of chairman can be fulfilled, constrained only by the recommended practice contained in the Combined Code, which states that the chairman should be independent and that the role should be separate from that of chief executive.

In practice, the role therefore tends to vary in style, in the time devoted to it and in the power exercised. The one aspect of the role that is universal is responsibility for the functioning of the board. A good chairman is the dominant factor in the efficient operation of the board, and therefore a strong influence on the effectiveness of the non-executive directors.

2. *What should be the key roles of non-executive directors on the board and what should be the balance between the different components? Within a board, should all non-executive directors be expected to fulfil each of the different roles?*

Non-executives fill a variety of roles on the board. In terms of their relative importance, our survey revealed the following assessment.



As we stress later, when answering questions on effective performance, we believe too much emphasis has been put on the role of the non-executive as watchdog. That is far from being the most important aspect of the role.

It is true that non-executives have a monitoring or supervisory role, particularly in situations where the executive directors may have a conflict of interest. That's not something we wish to ignore or minimise, but the overriding consideration is that non-executives should participate to the full in the board's main task of directing the company.

Non-executive directors have both a collective responsibility shared with the executive members of the board for the overall direction and performance of the company, and also individual contributions relating to their specific areas of expertise and to any roles they might have on board committees. They therefore have a wide variety of expertise and backgrounds. Getting the right mix is a key to getting the right board.

The particular contributions that non-executive directors might be expected to make are:

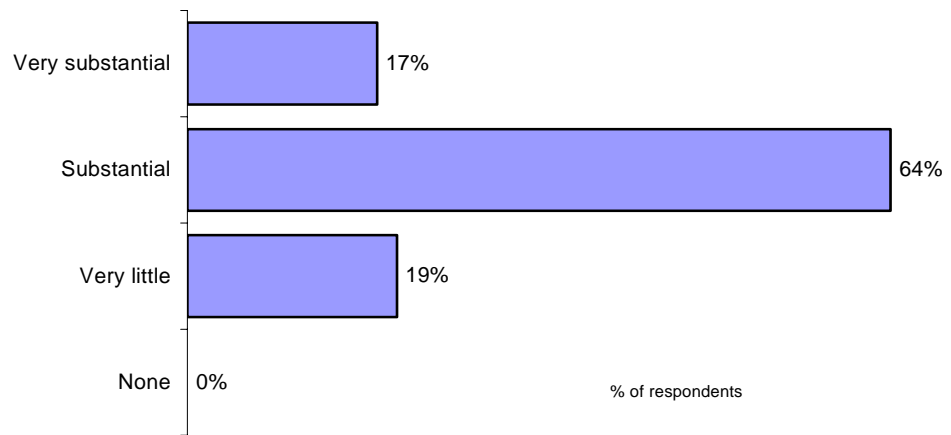
- To widen the horizons of the board in formulating strategy, applying both a wider general experience and any relevant special skill and knowledge that the board might otherwise lack.
- To test management thinking and to monitor the performance of the company in pursuing the agreed goals.
- To ensure that the board has adequate systems to safeguard the interests of the company where these may conflict with the personal interests of individual directors.
- To ensure that essential information is available and understood at board level and that there are adequate high-level controls.
- To play a key role in the appointment of the chairman and chief executive.
- To ensure (particularly with an inexperienced board) that the obligations of the company to its shareholders and the outside world are fully understood and kept in mind.

3. *How does this compare to the present position?*

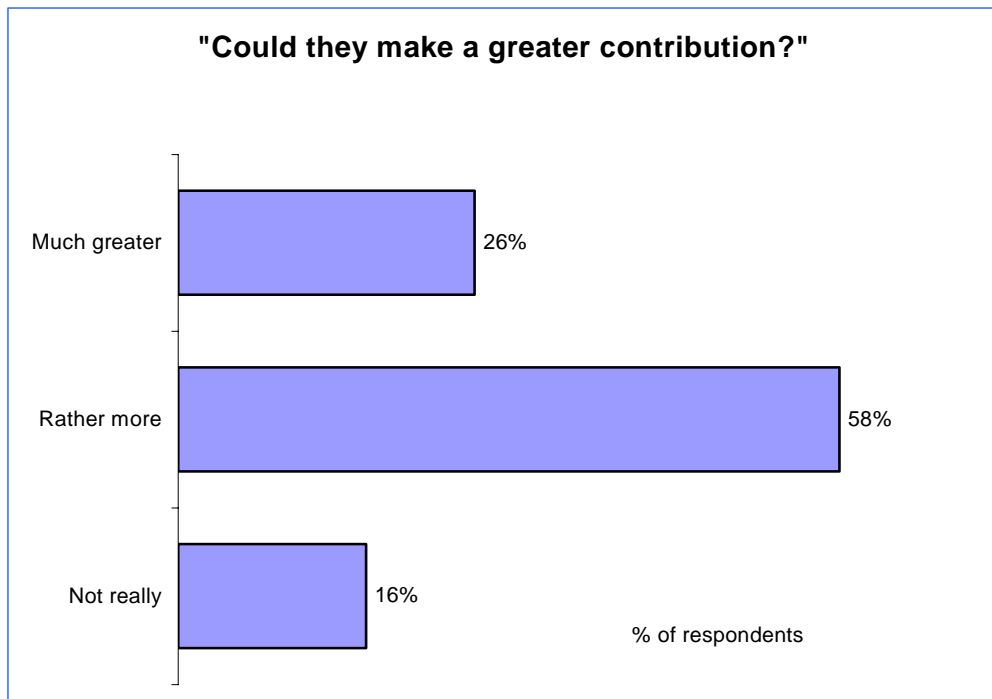
We believe that non-executive directors already make a substantial contribution to the effective operation of UK boards and thereby to the performance of the companies concerned.

This belief was borne out by the results of our survey.

"What contribution do you feel non-executive directors currently make to the effectiveness of UK boards?"

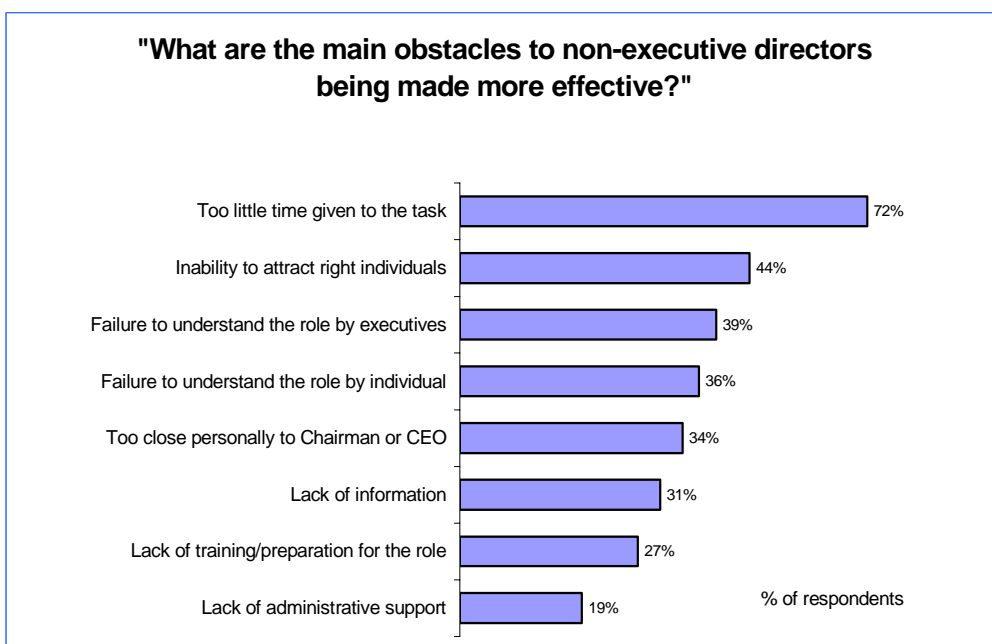


However, we, and the respondents to the survey, also believe there is considerable scope for improvement.



There are many examples of very well run boards and highly effective non-executive directors. The challenge is to make these examples of excellence the norm.

Directors in our survey also listed the most important obstacles to the effectiveness of their non-executives.



4. *How independent do non-executive directors need to be for the different roles?*

Above all, independence is an attitude of mind and a matter of personality rather than anything else. Truly independent non-executive directors will look at a matter entirely from the perspective of what is right for the company, regardless of the implications for themselves or the acceptability of that view to the other board members.

Independence is easily recognised in practice but impossible to relate simply to a set of conditions in advance. Clearly someone who has a major personal interest in the financial performance of the company, or who represents a controlling or significant shareholder cannot be regarded as independent. Nor could someone who is married to the chairman or chief executive. Beyond this, it is harder to define what 'independent' means. The ABI and NAPF have their own definition, PIRC another and Hermes another. All of these would disqualify some individuals whom most people would regard as very independent. Our view is that what's needed is intelligently applied guidelines, not rigid 'tick in the box' criteria.

A common factor in recent major corporate failures has been an overly dominant personality at the centre. This is true whether the cause of failure was wrongdoing or wrong strategy. The type of independence needed to counter this requires strength of personality; it is nothing to do with any pre-qualification for being considered 'independent'.

5. *What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a role in protecting the interests of the company? What can be done to help non-executive directors to be effective in relation to these conflicts?*

As we stress later, we believe too much emphasis is being placed on the role of non-executives as 'watchdogs', as the custodians of ethics and probity.

We accept this is an essential component of the role, but any good non-executive director – or for that matter any good executive director – should be expected to act where the board or any other director is clearly not acting in the best interests of the company.

The obvious potential conflicts where a non-executive can help protect the company's interests are:

- Remuneration of executive directors and, to a lesser extent, non-executive directors.
- Accounting issues, in particular where they affect profits or other factors that may have an impact on a director's bonus or pay-out under an incentive scheme.
- Transactions that may have a significant impact on a director's financial reward or future career.

Less obvious conflicts occur where, say, the chairman or chief executive is following a line of action that suits their personal agenda but doesn't fit the long-term interest of the business. He or she may not see it that way and it may not be that obvious, but the underlying personal motivation is taking the company off track or putting the business at risk.

A case might be where the chairman or chief executive is for or against a bid for the company because of the personal implications, or where a strategy is being blindly pursued because the chief executive or chairman is personally – and publicly – wedded to it.

These are not always easy situations to spot, let alone deal with, and 'codes of practice' won't help. What's needed is non-executive directors with the perceptive skills and strength of personality to surface the issues. These characteristics are essential to the non-executive role.

There is nothing that any code of behaviour or set of recommended best practices can do to compensate for a poor choice of non-executive director.

6. *What time commitment is needed for the role of Chairman and for non-executive director roles, and how far does this vary between different companies? Are there any implications for the number of non-executive posts that one person can sensibly take on?*

There is widespread concern about non-executives having insufficient time to do their job properly. We share that concern.

Indeed, in our survey it was cited as the main obstacle to effectiveness.

Too many non-executive directors take on their roles without recognising just how much time – as well as energy and attention – it can take. It is not just a matter of attending board meetings, or sub-committee meetings, nor even of having enough time to read the papers and prepare for meetings properly. It is a matter of being available, when required, to respond to issues. These may range from taking phone calls or attending ad hoc meetings, to becoming much more fully engaged in times of crisis. When there are major issues within the board, such as needing to replace the chairman or chief executive, or when the business is facing severe financial problems or facing a takeover bid, the time requirement can increase dramatically.

It is under these circumstances that the role of the non-executive director is often at its most important.

Some have suggested that there should be a rigid limit to the number of directorships that an individual can hold. Whilst accepting the sentiment, we think this is impractical. We also believe it misses the point.

First, there is the problem of defining and policing the number of directorships held. Because of the complexity of company structures, membership of a board often involves automatic membership of several other boards, even though these don't operate as separate entities. The records at Companies House, therefore, list more 'directorships' than genuine roles.

Second, the number of directorships that an individual can sensibly undertake depends on many other factors:

- Whether he or she also has a full-time job.
- Whether he or she is chairman of this or any other board.
- Whether he or she chairs any of the important committees of this or another board.

Moreover, it isn't only the number of directorships that dictate availability of time. An individual might, for example, have a role in one or more charities, be a school governor, sit on one or more government bodies, have an academic post, be the captain of the golf club, or travel widely as part of another commitment.

All of these, and other, commitments dictate how much time and energy an individual can really give, and how much time he or she might have available if the pressures were to grow.

It is for the company making the appointment to satisfy itself that any candidate for the board really does understand what is involved and that they genuinely have the time available. Too often, the reverse is the case: the company is so keen to get the individual that it minimises the potential commitment.

We suggest the following guidelines for the appointment of non-executives:

- No individual should chair more than one major company (such as a FTSE500 company).
- A full-time executive should hold no more than two non-executive directorships.
- No individual (even if not an executive) should be on the board of more than six substantial organisations (such as a listed company, a major charity or a quango).
- No individual should chair a similar committee (such as Audit, Nomination or Remuneration) in more than one company.
- There should be no cross-appointments:
 - Chairmen should not sit on each other's boards.
 - Members of the Nomination Committee and Remuneration Committee should not sit on each other's boards.

These would not be statutory requirements, but companies should report on whether they are observing them and, if not, explain why.

However, in the desire not to see non-executives over-stretched in terms of their commitments, it is important not to lose sight of the counter-balancing requirement, which is for breadth of experience. And it isn't just past experience that matters, it is current knowledge and insights. It is important for non-executives to provide the board with a perspective on how the wider business world views current market and economic conditions or on how other companies are responding to various developments and pressures. Multi-board experience is also important in promoting the spread of best practice, a recurring theme in our submission.

7. *Should there be a role for a “senior independent” non-executive director?*

Our survey revealed a surprising level of support for the idea of a ‘senior independent’ director; surprising because it could be argued that this is the role of the chairman. Yet 74% of the respondents supported the idea.

There could be several advantages from having a senior independent director. Such a role could provide leadership for the non-executives, although it is questionable if they need leadership – it is surely board leadership that matters. A senior independent director could provide a focal point if the non-executives felt they needed to get together privately on an issue. However, given the strength of character of most of them, they could normally be expected to do this anyway if circumstances demanded. A senior independent director could also provide an alternative point of contact for shareholders, but as we point out later, this has both advantages and dangers.

In summary, we can see some merit in the idea of a senior independent director, but would not want to see it made obligatory. We believe the role is more appropriate for larger companies and makes more sense if it is combined with chairing one or more of the key committees such as Nomination, Audit and Risk or Remuneration.

8. *Do you have comments on the proposed statutory statement of directors’ duties, which does not seek to distinguish between the legal duties of executive and non-executive directors?*

We believe there should be no legal distinction between different types of director. Every member of the board should have the same over-arching obligations.

In fact, we don’t particularly like the term ‘non-executive’, especially when it refers to the chairman. Anyone who can, if circumstances require, replace the chief executive surely has to be regarded as pretty ‘executive’.

The basic distinction is that non-executives are not employed to run the business on a day-to-day basis; as opposed to their board colleagues drawn from the top management of the business. We would prefer to use the term ‘independent director’, but recognise that this raises questions about the definition of independence.

A non-executive director is not an observer or advisor, nor a consultant on a low fee with a fancy title. He or she carries the same obligations and has the same powers within the board as every other director. And that's the way it should be.

B: Attracting and appointing non-executive directors

What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?

9. *What are the key skills, knowledge and experience which are needed by non-executive directors to perform the role effectively, and how is this likely to change over the next, say, 10 years? Are some skills essential and, if so, what are they?*

There is no such thing as a 'standard' non-executive director. Indeed, a board needs non-executives with a mix of skills and expertise complementing each other and also complementing the expertise of the management team.

The skills might relate to a specific discipline such as technology or finance, or to a particular market, say overseas. Or non-executives might be appointed for their knowledge of particular situations, such as IPOs or buyouts.

Requirements change over time, and boards should continually evolve with progressive refreshment of the non-executives. We believe that normally two, three-year terms should be the limit, with a third term only as an exception.

The one specific knowledge every non-executive director requires is a proper understanding of the role and functions of a board.

10. *What personal qualities and attributes are needed?*

Although the background and experience of non-executives can vary widely, they need a common set of personal attributes:

- They must be independent: that's independent of mind, not any other definition.
- They must to be able to see a situation in perspective.
- They must to be able to probe and question the executive members of the board, whilst remaining supportive.
- They must to be able to stand up to the strength of personality of the chairman or chief executive.

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- They have to command the trust and respect of the executives.
 - They must have integrity.

Essentially, a non-executive director should provide an independent and impartial view of the board's considerations and decisions while also identifying strongly with the company's affairs. It is essential therefore to look for strength of character and an ability to stand back from the issue being considered, combined with pragmatism and an ability to compromise. This calls for personal qualities of courage, integrity, common sense, good judgement, tenacity, diplomacy, and ability to listen carefully and to communicate with clarity, objectivity and brevity. These qualities are easy to list, but not to find or even to assess if you don't already know the individual.

11. *What sort of mix of experience and attributes is desirable on a Board? Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.*
12. *How easy is it to recruit non-executive directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?*
13. *What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?*

Our survey respondents cited the inability to attract the right individuals as the second most serious obstacle to the effectiveness of non-executive directors. Overcoming this obstacle means doing three things: making the role more appealing, casting the net more widely and having a more effective recruitment process.

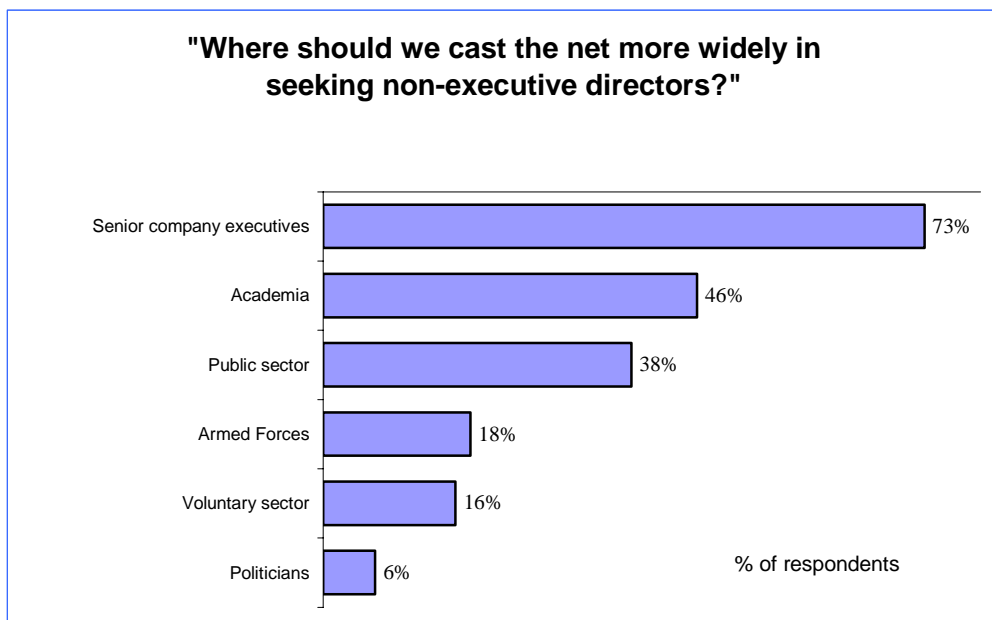
There is no doubt that too many non-executives have been chosen in the past because they are highly respected, widely-known, names: individuals that look good on the company's letterhead or listed in the annual report. Such appointments are not necessarily bad appointments; nor are we saying that company image doesn't matter. However, choosing non-executives in this way doesn't create the balance of expertise and skills that we advocate. It also narrows the pool and leads to individuals ending up with too many directorships and accusations about 'the old boy network'. Indeed, many of those

individuals who end up with a string of directorships do so because of a failure to resist pressure from associates rather than from any desire to extend their commitments.

Instead, the task of appointing non-executives should be approached more methodically: to consider the type of skills or expertise required, to commission a search and to undertake a proper selection process.

Moreover, companies should be prepared to widen the search. There are many excellent non-executives who are not household names but are making a significant contribution to boards.

This was the view of our survey respondents:



Probably the biggest under-tapped area of potential non-executives is senior executives who are not yet on the main board in a large business. They may well run a division or perhaps a subsidiary company within their group. They are likely to be highly experienced, numerate and used to analysing situations, and understand all the major financial aspects of running a business.

Such an appointment is also valuable to the individual's personal development: which is the reason why their full-time employers are increasingly ready to accept the idea.

There is also an increasing trend for women and ethnic minorities to be appointed as non-executives. Whilst accepting that in a few cases the motivation might relate largely to appearances, this is nevertheless a welcome trend. It casts the net more widely and it is good to see board membership more accurately reflecting the make-up of the workforce and the customer base.

A good Nomination Committee can be key in seeking out, recruiting and appointing the right non-executives. It is also a safeguard against 'old boy' accusations. However a balance needs to be kept. Essentially it is the role of the chairman to ensure a well-functioning board; that involves balancing both personalities and expertise. You cannot have an effective team captain who plays no role in the selection of the team. Moreover, in persuading an individual to join the board, he or she is far more likely to be attracted by the chairman or perhaps the chief executive than a committee. It should also be remembered that the Nomination Committee is a sub-committee of the board, not a separate entity.

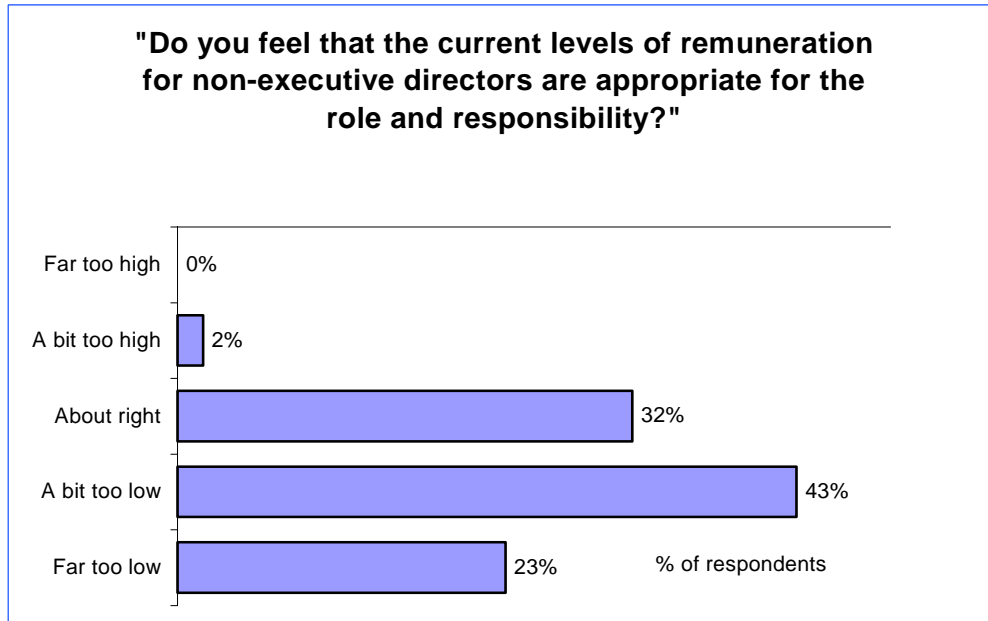
The criteria for appointing an overseas director to the board should be exactly the same as for any other non-executive director – namely what particular skills and experience the individual brings, how this complements the other capabilities on the board and whether he or she has the required personal attributes.

There are two good reasons such an appointment might be appropriate. The obvious one is where the company has, or is planning, significant overseas activities. The other is where the nature of the business relates to an area or a market (such as high technology) which is more advanced elsewhere.

Beyond this, we can see no reason for bringing onto the board an individual who has no understanding or experience of the issues (commercial, legal, political and ethical) and imposing on them all the responsibilities under UK law and practice to promote the best interests of the company.

14. *Are the rewards for non-executive directors appropriate, both in terms of levels of pay and the form that remuneration takes – e.g. cash/shares/share options? Are current pay levels a significant factor in whether good non-executive directors can be attracted?*

There is a widespread feeling that non-executives are somewhat underpaid for the task that they perform, the influence they can have on performance and the responsibility they carry. The views expressed in our survey were as follows:



Asked to put these views into hard, present day numbers, the statistical medians of the opinions were:

<u>Type of Company</u>	<u>Median £</u>
FTSE 100	40,000 – 60,000
Any other quoted company on the full market	25,000 – 40,000
AIM listed company	15,000 – 30,000
Unquoted company large enough to have a formal board	15,000 – 25,000
(views of surveyed directors)	

These ranges would normally exclude the role of chairman where as we have said, the nature of the job and the time required can vary greatly. We believe that the total remuneration for non-executives should be made up of a standard fee for being on the board plus a separate payment for chairing or being a member of any major committee.

The overall feeling of our surveyed directors was that non-executives' remuneration should be in cash, not shares or options, and should be a fixed fee, not performance-related.

We agree with these conclusions and believe that fees are too low. They may not actually impair recruitment but they are out of line both with the contribution non-executives are expected to make and the responsibility they are required to bear.

However, a chairman or chief executive needs to be able to call on non-executives for additional opinions and support without feeling they are asking for more than they are paying for. And non-executives need to be able to do their job, conscientiously and whole-heartedly, particularly in times of pressure without feeling they are being put upon.

We are against rewarding non-executives with options, and to a lesser degree with stock. The experience from the USA shows the dangers of boards becoming obsessed with share price rather than underlying company performance.

Moreover, not rewarding with stock adds to independence. Faced, for example, with a takeover bid, a non-executive can take a stance free of any concerns – or accusations – of having a financial stake in the outcome.

However, we would accept a part payment of fees in shares provided they were held for a minimum period.

We make one exception. For smaller, unquoted companies it may well be appropriate to reward a non-executive director by way of stock rather than cash. This is both a means of attracting an individual that could otherwise not be afforded and a way of getting unity of purpose within the board, with everyone having a shared stake in the achievement of the company's ambitions.

Stock options and grants are appropriate to developing smaller businesses, not to quoted companies. Independence, in terms of not having a personal financial stake, becomes a key issue as soon as the interests of a wider shareholding has to be considered.

15. *Do you have comments on the issue of risks or insurance provision for non-executive directors?*

The obligations and liabilities facing all directors are extremely heavy. Within the UK governance structure we don't see how it could be otherwise. To use a cliché "it goes with the territory".

This underlines the importance of two things: ensuring individuals joining the board fully understand the role, and making sure that non-executives have open access to key information.

The level of responsibility also has a bearing on the question of the appropriate level of remuneration, which we covered earlier.

Certainly the risks for a non-executive – to reputation as well as financial – are always likely to be high compared with the rewards. These risks are increasingly significant as a result of the recent trend in the UK to litigate more readily. We are not questioning that directors who have failed to carry out their duties properly should be liable for the loss caused by their failures. The tendency now, however, is for litigation to be brought (or at least seriously threatened) against all members of a board where the company has failed or simply suffered a serious setback.

For a non-executive director – even if only recently appointed – this can have extremely serious consequences. Even if in due course the litigation is dropped or dismissed, they will have spent many months, possibly years, engaged in defending themselves and their reputation. The time spent on this, including the collation of all evidence that could have any relevance and the numerous discussions with professional advisers, will seriously disrupt their life. The time spent on this defence will be out of all proportion to the time the non-executive directorship was ever intended to involve. Even if there is spare time for other business interests, the individual's reputation and judgement may be under a cloud, which might make it extremely difficult to obtain any new position.

In addition there are the financial consequences of any such claim. The non-executive director may expect that the costs of the litigation will be borne by a professional liability policy. However, insurers might well seek to avoid liability if they can see grounds for doing so. For example, the insurers who wrote the professional liability policy for the board of Equitable Life have taken the line that the claim by the current board against the former directors falls outside the latter's policy. Thus, the

directors might face a second law suit, making a claim against the insurers as well as defending the claim against themselves. In the absence of adequate insurance cover, the directors could face financial ruin purely as a result of the professional costs incurred, regardless of any liability to the company or its investors. Even if the claim fails, the director is unlikely to recover the total amount of costs incurred in defending the case.

The Equitable Life case illustrates another issue for non-executives: an underlying problem at a company may well originate from a date before they had any connection with the business. Often no amount of due diligence by the prospective non-executive would have revealed the problem. Ultimately, of course, one cannot be held responsible for the consequences of actions or decisions pre-dating one's arrival. However, that is of limited consolation if you have spent a fortune on legal defence and put your life on hold for a couple of years.

Many people will be watching to see how the position of the ex-directors of Equitable Life, who are being collectively sued for £3 billion, unfolds. Given the present circumstances why would anyone in future seek or accept the responsibilities of becoming a non-executive director?

No one should join a board without recognising the responsibilities and liabilities, and no one should do so without adequate insurance. Companies need to look carefully at the extent, terms and conditions of what insurance is being provided.

C. Structures and accountability

Do existing structures and procedures facilitate effective performance by non-executive directors?

16. *How is the Combined Code working in practice? In particular, how are the provisions on the balance between executive and non-executive directors and the role of independent non-executive directors working? Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?*

The Combined Code, following on from the Cadbury and Greenbury reports, has certainly had a substantial effect on corporate governance. The successive reviews have raised awareness of the issues and progressively laid down rules for behaviour that have been widely adopted.

However, all these initiatives have largely focused on issues of probity. Which is hardly surprising given that they came mainly in the wake of major scandals. Measured in terms of diminishing the likelihood of another 'Maxwell', they have been highly successful.

But good governance is not solely concerned with ensuring probity, and a highly effective board performance is not simply about avoiding wrongdoing. The downside of these governance reviews is that they have emphasised the role of the non-executive director as a watchdog, the custodian of proper behaviour. That is neither the most important aspect of the role nor the main appeal of the job.

As discussed in our response to Question 4, there is a need for a more widely accepted definition of independence: clearer in principle, less prescriptive in terms of qualifying criteria.

17. *Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors? Are board meeting procedures working effectively? Do you have comments on board size?*

We believe that the three key standing committees – Nomination, Audit and Risk, and Remuneration – provide the right framework from the standpoint of good governance. They also provide the right platform for a significant, indeed essential, contribution from the non-executive.

We think most board processes work quite well; they work at best in larger companies, less well in smaller and younger companies.

Board size is always a balance between getting the right mix of skills and representation and not becoming too large to be effective. In the smaller organisation, the former tends to be the issue: in the larger, the latter.

It would be wrong to be too prescriptive about board size – conditions vary, but for a publicly quoted company 12 would be a reasonable norm, with the non-executives in the majority.

18. *Do you have comments on the composition and duties of Audit Committees? How effectively are Audit Committees working in practice? Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?*

We believe Audit Committees – or rather Audit and Risk Committees – have a very important role to play in a company's life. They are not there simply to ensure that the audit is properly carried out and that the board (which always carries the ultimate responsibility) can sign off the figures with confidence. They are there to ensure that risk, in all its forms, is properly identified, assessed and handled.

The role of the committee is not to manage risk, it is to ensure that risk is being managed.

Any director, executive or non-executive, should feel uncomfortable and exposed without the existence of a powerful and competent Audit and Risk Committee.

The issue is not one of strengthening the code, it is one of strengthening the committees. Anyone who has seen a first class committee in practice, and seen the kind of reporting (in quality and clarity, not volume) they receive, would know what should be expected. The best practice is excellent, the problem is spreading that practice. Auditors can have an important role to play in this.

Some believe that non-executive directors should appoint the auditors, or at least make the recommendation to the shareholders, who formally make the appointment. 62% of our respondents supported this view.

The IoD endorses this view and recommends that the Audit and Risk Committee, dominated by non-executives, should be the vehicle for doing this. We would, of course, add that the committee should consult the finance director fully in advance. The non-executive members of the committee should also be given the opportunity to review the conduct and outcome of the audit, in private, with the auditors.

A final point worth making: a strong and effective internal audit department can be of great value to the committee, as well as being an asset to the business.

19. *Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?*

Nomination and Remuneration Committees have a similarly important role to play, and here, again, it's to do with spreading understanding and best practice.

Every director who sits on such a committee starts out with the intention of doing a good job. But diligence, integrity and good intentions are not enough; they have to understand how to do the job. If a director doesn't have previous experience of such committees, he or she will require preparation for the role.

Some have argued that the Remuneration Committee should comprise only non-executives. That might be appropriate if the committee deals solely with board remuneration. However, in many organisations it also deals with the broader remuneration policy, particularly looking at incentive schemes, option awards, contract terms and salary levels for other top executives. Such an approach has much to commend it. Under these circumstances it would be ridiculous for the chief executive not to be a member of the committee. It would therefore be more sensible to say that Remuneration Committees should be made up predominantly of non-executives and that any executive director, or the chairman, should be excluded from that part of the discussion affecting their own or their peers' remuneration.

There is a further important point concerning Remuneration Committees: their prime function is to devise and apply policies that attract, retain and motivate the top team, not to satisfy appearances to the outside world or the requirements of 'good governance'.

Any external advisors on board remuneration should be appointed by the Remuneration Committee not the management.

We believe that the chairmen of both the Remuneration and the Audit and Risk Committees should be on the platform at the AGM, ready to answer questions. They should also be available for discussions with major shareholders as and when required.

20. *What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?*

We are not convinced that objectives for the board, as opposed to the company, should matter to anyone outside the company. And we certainly don't see a general case for setting formal objectives for individual directors. At any level in an organisation, objectives are a balance between individual and team goals. At board level, it is the latter that dominates.

A once-a-year board 'Awayday' can be a powerful aid to setting both direction and goals. An off-site gathering provides an opportunity to step back from the routine business of regular board meetings to look at strategic issues. It has the added benefit of helping the board think and act as a unit.

21. *Could more be done to review performance? Should more information on board performance be reported to shareholders? Should companies provide more information on the performance of non-executive directors?*

Good boards continually review their own performance, or at least they look for ways to function better as a board. A periodic review, if necessary with outside facilitation, can ensure that underlying concerns or frustrations are dealt with before they become serious issues. That's particularly important as the composition of the board evolves over time.

It should be remembered that board performance is a means to an end, not an end in itself: the end is company performance. That is what is reported to shareholders, and it is what a board is judged by. No shareholder is likely to say "what a great board performance – pity the results are so abysmal". Nor are shareholders going to turn on any board consistently delivering first class results.

And, given the unitary board structure in the UK, there is no case for reporting separately on the performance of a limited sub-set – the non-executives– of the board. Anyway, how would an outsider judge their performance? By the number of meetings attended?

22. *Are non-executive directors able successfully to challenge executive decisions or expose serious problems? Should it be made easier for them to do so and, if so, how?*

The ability of non-executive directors to challenge executive decisions (which they have every right to do) or expose serious problems stems from their personality not from process. Strong individuals will always find a way of challenging; weak ones shouldn't be on the board.

If a challenge is unsuccessful, the ultimate sanction is, of course, resignation. Some have suggested that non-executives should be more ready to resign. That's easier said than done. The question is not one of readiness to resign, it is a matter of when it is appropriate and where it is possible.

Directors cannot simply walk away from problems in the company; they do not have the same freedom to resign that employees have. Once appointed, directors of a company are under a duty to act in its best interests, and that may well constrain them from resigning when things they don't like are happening.

A director will be in breach of fiduciary duties if his or her resignation facilitates a breach of duty by other directors. Thus, if a non-executive believes that the other directors are acting in a way that cannot reasonably be regarded as being in the best interests of the company, he or she will not normally be free to resign. They would only be free if they had done everything else – without success – to stop the other directors from following their proposed course of action, and believe that resignation itself would stop things.

Directors must also remember that the duty of confidentiality does not end with resignation, and any subsequent disclosure of the circumstances must pass the strict test of being in the public interest.

Non-executives are, of course, normally free to resign if they merely have a difference of view on policy. But this freedom does not apply where wrongdoing is occurring or in prospect. And wrongdoing does not just mean fraud – it includes any breach of duty by other directors, such as failure to exercise proper skill and care.

Moreover, whatever the reason, a director must always weigh up the damage that resignation will inevitably do to confidence in the company.

So, resignation can only be a last resort in very specific circumstances. It is not simply a matter of being principled or strong-minded, as some might assume.

The ability to challenge executive decisions also depends on the availability of the right information as we stress in our response to Question 27.

D. Relationships with shareholders and others

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

23. *How well do relationships between non-executive directors and shareholders and stakeholders work, and could they be improved? For example, we would be interested to hear views on what the relationship might be between non-executive directors and institutional shareholders? How could this relationship be strengthened?*

Before suggesting ways in which the relationship between non-executives and institutional shareholders could be strengthened, it is first necessary to ask whether it should be strengthened.

We put this question to our surveyed directors, who gave us the following response:



We agree. Institutional shareholders should, if they seek it, have the opportunity to speak to the non-executive directors. This might be the non-executives as a group, one of the key committees or simply the chairman of a particular committee. There can be value too in having individual non-executives accompany the chairman, chief executive or finance director on any of their visits – or ‘road shows’ – to the institutional investors.

Note that we are not advocating regular and routine meetings between investors and non-executives, an idea floated by the Myners review. We can see the merits but also the dangers. On the positive side, such meetings could give greater insights into how well the board was operating. They would also give the non-executives a greater understanding of investor sentiment and expectation, rather than relying on the chairman or chief executive's interpretation.

On the negative side, there are two dangers. The first is that the non-executives are segregated out as a separate group rather than remaining integral members of the board. The danger here is that because the non-executives report separately, they have to be handled and briefed separately - and perhaps treated with a little more circumspection - by the executive directors.

The second danger is that investors wouldn't actually treat this facility as Myners intended. The vision is one of a discussion on strategy and company development, and on the structure and effectiveness of the board and a chance to be reassured that there are no major concerns within the board. The reality might be further probing of the one issue that preoccupies all investors and analysts: the likely financial results.

Given these fears and the danger of creating a split board and an alternative route of reporting, we would not make this Myners proposal either obligatory or even recommended best practice.

Institutional investors should feel they can have access to the non-executives, individually or collectively, if and when they feel the need.

24. *To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more that they could do, by promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows, or otherwise?*

Probably nothing has more influence on the operation and effectiveness of a board than the choice and quality of chairman.

The chairman dictates the whole style and tone of the board, encouraging open debate, bringing out differences of opinion whilst reaching decisions that command the subsequent support of the whole board. The chairman manages the potential personal conflicts. He or she also helps to focus the board on what really matters as opposed to simply ploughing through the agenda.

The chairman isn't simply the best or most experienced of the non-executive directors: it's a different role.

25. *What should be the relationship between the non-executive directors and executive directors, and with senior management? What should their relationship be with the Chairman and Chief Executive? What should their relationship be with key advisors to the company?*

The relationship between non-executive and executive directors should be one of people doing different jobs in the same team. The latter should feel that the former are there to help them succeed, not to check up on them.

The important thing underlying all relationships within the board is that there should be a common sense of purpose underpinned by mutual trust. Everyone is there with the same, single overriding aim: to ensure the success of the company. Board members may have different skills and different contributions to make, but it is a single team, which bears collective responsibility. Everyone bears the same fiduciary and legal obligations.

Listening to much of the discussion of a good board, you would not know who was 'executive' and who was not.

The executive directors should also feel free to consult individual non-executives on specific matters where the latter have specialist knowledge. Indeed, they should feel free to speak to any executive in the company, following of course the normal courtesy of mentioning this to the appropriate manager.

We would expect external advisers – lawyers, board-level consultants, financial advisors and the like – to regard the board, as a whole, as their client. However, non-executives should, if they require, have access to such advisers, in private if they wish.

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26. *How can Company Secretaries support effective performance by non-executive directors?*

Company Secretaries have an important role to play. They can make non-executives more effective in two ways. First, they can give guidance, particularly to the less experienced director on the functioning of the board: explaining the rules, the processes, the obligations, the timing of key events, the documents, giving guidance as to what is routine and what isn't, and so on. Second, they can play a key part in the information flows, ensuring that what is sent to the non-executives is timely and concise.

E. Support

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

27. *How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?*

The lack of available information was cited by our survey respondents as the sixth most important impediment to non-executives' effectiveness. Two areas need to be addressed: openness and system.

Executive directors need to understand that non-executives are entitled to open access to all company information. They bear overall responsibility and legal obligation for everything the company does and how it does it. But it isn't just a matter of access to raw data. Non-executives should be provided with a true and accurate picture of what is going on. They can't contribute properly if the latter is obscured from them. An experienced non-executive will always smell danger if information is unavailable or inconsistent. What matters is the nature of the information provided, not its volume or detail.

Non-executives need to be able to probe figures, particularly those relating to plans and forecasts: it's part of the process of testing management thinking. This doesn't mean non-executives are challenging the executive directors or trying to catch them out; they are there to provide assurance. Non-executives should be able to draw on their experience, and benefit from their lack of involvement in the day-to-day business, to give an analysis of a situation or point out trends that may not be apparent to the executive directors. These things can only be done if the non-executives are being fed figures and projections that haven't been screened or sanitised for their use.

The situation varies widely across companies, according to relationships between executive and non-executive directors, the openness with which the board operates and the efficiency of internal information systems.

Providing non-executives with relevant and appropriate information requires many things: better and more experienced chairmen, non-executives who know what to expect and what questions to ask, and better support systems.

-
28. *What training and development opportunities are available? Could they be improved and, if so, how?*

We believe that training and development have an important role to play in making non-executives, and indeed boards, more effective. This is an unsurprising view from an organisation that has a mission to raise the standards both of directors as individuals and of boards collectively, and that also offers training and development programmes.

However, it is a view that is increasingly widely shared. A 1990 IoD survey revealed that just 10% of directors participated in some form of professional development; by 1998 this had risen to 65%, with short courses being the preferred means.

However, the importance of training and development is not universally recognised. Too often there is still the assumption that, since only highly experienced people make it to the board (particularly of larger companies), training is not only unnecessary, but it would be offensive to offer it. This contrasts sharply with areas such as sport or the arts, where the best devote much of their time to getting better.

Promotion to the board is not just another step up the executive ladder; it's a different role. Being a top-quality non-executive is not just a matter of sitting round a table and contributing the odd word of wisdom based on a long and successful career – it's a new and demanding task.

Moreover, the issues faced by a board are continuously changing. The business has to be guided through expansion, downsizing, flotation, acquisition, bid defence, whatever. Sit on any board for a year and even the most experienced director learns new lessons.

Director development is a process of continuous learning, not a one-off 'sheep-dip'.

The IoD has been offering training and development programmes for both executive and non-executive directors for more than 20 years. In 1995, in collaboration with Henley Management College and with funding from the DfEE, we published "Good Practice for Directors – Standards for the Board" (updated in 1999 and 2001). This formed the basis for the IoD's Company Direction Programme. This programme leads to a formal qualification for directors entitled 'The Diploma in Company Direction' which has been awarded to more than 3,000 directors.

The Company Direction Programme has evolved as the corporate governance agenda has moved forward and as the regulatory environment has changed. The programme, which is formally examined, now covers the following fundamental areas of best practice:

- The role of directors and the board
- Legal duties, liabilities and the regulatory environment
- Effective decision making at board level
- Finance for directors
- Strategic direction
- Human resource strategy
- Marketing strategy
- Leading and directing change

In 1999, the IoD launched the Chartered Director Initiative. This further promotes the importance of director development and recognises the importance not just of knowledge and understanding, but of board-level experience and good practice.

Chartered Director is the world's first professional qualification for directors and provides a rigorous test of knowledge, understanding, experience and probity. It sets a standard against which all directors can and should measure themselves, and has been endorsed by the DTI, IiP and NAPF, amongst others. To date, 115 individuals have been elected to Chartered Director and have signed up to the IoD's code of conduct. Chartered Directors have come from many areas and disciplines including the private, public and not-for-profit sectors.

The IoD also runs several programmes specifically for non-executives, including courses and conferences such as "The Role of The Non-Executive Director" and (in collaboration with Ernst & Young) "The Independent Director Initiative". The latter is an experience-sharing and networking programme for experienced non-executives.

Last year, more than 5,000 directors attended IoD courses on topics including:

- The role of chief executive
- The role of company secretary
- Corporate social responsibility
- Employment law update
- The role of the chairman
- Buying and selling companies

Developing strategic thinking
Chairing meetings
The family business

Programmes offered by other organisations include 3i's Independent Director Programme and Henley's Centre for Board Effectiveness. In addition, several other business schools, including Ashridge and Cranfield, are beginning to look seriously at corporate governance courses. The big consultancies and other professional institutes (especially ICAEW and ICSA) also run workshops in this area for their clients and members.

Training is, therefore, widely, and increasingly, available. The one area where we feel more could be made available is in the continuing development of experienced non-executives: giving them an opportunity both to share experience and to understand and examine current developments in the business environment. This could, and indeed already does, take many forms: short courses, workshops and 'clubs'. One example of the last is the IT Non-Executives Association run specifically for non-executives on the board of IT companies: a group that must have felt particularly challenged in recent times.

29. *Can induction for non-executive directors be improved?*

We believe the induction process for directors could be improved.

There are two induction needs: one for directors new to board responsibilities, the other for directors new to the particular company. The former we have just covered; the latter ought to be relatively straightforward but it is surprising how many companies do not give it the attention it deserves. Too many directors join boards having been given little more than a copy of the last Annual Report and a set of past board minutes.

The very least a company should lay on is a proper induction programme lasting one or two days. It should provide the opportunity to meet key executives and visit key locations, and include a separate schedule of meetings with individual board colleagues.

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30. *Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?*

There are different aspects to the question of expectation. First, there is the question of what is expected of an individual when he or she joins the board in terms of both commitment and the particular contribution that is sought. No director should join a board unless he or she is clear on the reasons why they are being invited to do so. “We think you would make a very valuable contribution” is not enough. A mismatch in expectations here is possibly the most widespread cause for regret over a non-executive appointment.

If the chairman doesn't give any necessary feedback on a non-executive director's performance, then you have simply got the wrong chairman.

Non-executives also have a further set of implied expectations to do with responsibilities to shareholders. They are expected to be custodians of the shareholders' interests and upholders of good governance – if necessary to the detriment of their chairman's or their colleagues' expectations. For example, an individual might have been invited to join the board primarily for his or her specialist expertise in a particular area; however, the non-executive's major pre-occupation might – quite correctly – become the conduct of the board or the performance of the company.

So, 'meeting expectations', in the sense of what was originally expected by the chairman or the board, might not be the sole criterion for judging performance.

F. Smaller listed companies

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

31. *To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?*

The principles of good governance apply to companies of every size. However the application clearly needs to vary with scale.

Smaller companies need fewer non-executives but the role is every bit as important, particularly if a business is developing quickly, perhaps intent on flotation or if already quoted, on expanding its size or markets. Here the role becomes much more one of mentoring; the non-executive has seen a situation or been through a process that the executive directors haven't. There is also often an important aspect to the role of conveying how a board should operate as it increasingly takes on external obligations.

The important point is not so much the rules for best practice as the choice of the right individuals. What would help most in this area would be for investors, particularly venture capitalists, to take a strong interest in the appointment of non-executive directors. In fairness, many of them do. We would like to see the appointment of the right non-executives become a universal condition for making any investment in smaller businesses.

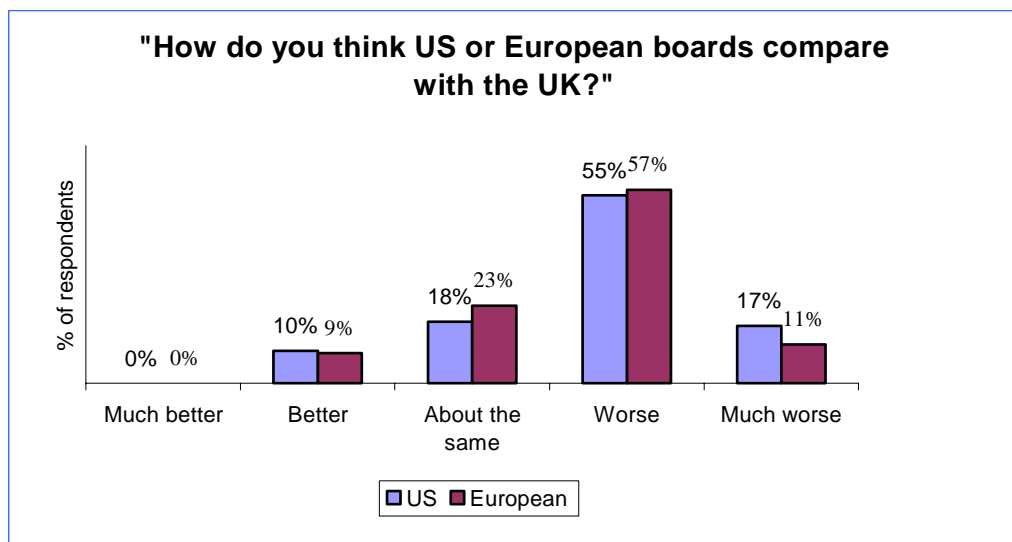
G. International Context

What can we learn from international experience?

32. *What lessons can be learnt from international experience, either in terms of structures or behaviours?*
33. *Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?*
34. *Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?*

The structure and operation of UK boards is different from those in either the USA or continental Europe. In the former, boards tend to be staffed with senior figures unconnected with the company, often with only the chief executive providing the link. In continental Europe, there is a two-tier system, with a supervisory board made up entirely of non-executive directors. Arguments can be made for the merits of both those approaches.

However, our survey of those directors with familiarity with the different systems, (70% of the respondents) produced the following comparison:



Our assessment is that the UK model of governance is currently as good as, and possibly better than, any other. It has the merit that the non-executive directors are closer to the action: they see the board in operation, they see how well it is chaired, they have the chance to quiz the senior executives, they are there when the strategy is formulated, they participate in the key decisions and they share accountability for company performance.

The UK model is much more demanding of non-executives than the other systems, but we believe it offers the best of both worlds: it brings independence and objectivity to the board whilst keeping the non-executives close enough to the action to have an effect on the performance of the company.

The IoD's Recommendations

Throughout our response to the Consultative Document we have stressed that non-executive directors have to play a wider role than that of simply being custodians of ethics and proper behaviour. We are not minimising the importance of the latter – integrity underpins everything the IoD stands for – it is simply that it isn't the main priority for improved performance.

Any current debate about corporate governance is inevitably taking place in the shadow of the recent appalling corporate scandals in the USA. However, it is important that this doesn't distort the debate. The recent US failures relate to (alleged) fraud, flawed accounting practices and falsification of market information. The most recent, and perhaps most dramatic ever, UK collapse relates to bad management.

The situations in the UK and USA are different. The UK doesn't have the same governance systems, board structures, business cultures or auditing philosophies as the USA. In the light of earlier UK scandals – Maxwell et al – governance procedures here have been tightened appropriately.

It is time to concentrate on today's issue – company performance – rather than on yesterday's, which was probity. This is not advocating complacency; we say it with a real concern to advance standards.

We believe the basic UK model for corporate governance is sound and that non-executive directors have a key role to play in making it effective. However, we also believe that there is considerable scope for improved performance. The main concern should be for better-run boards and better-managed companies. It is not the occasional catastrophic failure that affects pensions, savings and jobs; it is the vast number of organisations that fail to fulfil their full potential.

As in many walks of life, the problem is not with the best – which in any case tend to be those who continuously question and strive to improve – nor even with the woeful few whose performance hits the headlines. The problem lies in the bulk of companies whose boards could perform much better if they were aware of, and could adopt, best practices.

In a world that grows more complex, where technology changes structures and processes, and where markets become more international, the problem of governance is never going to be 'solved'. The way we run our organisations and the way boards perform will be kept under the spotlight, and standards need to be kept continuously under review.

Indeed, what is needed is not a series of ad hoc reviews – Cadbury, Greenbury, Turnbull, Myners, Higgs – but an ongoing review of best practices. The move to the Combined Code was a step forward but not the end of the road.

In looking for improvement, the IoD does not see further regulation as either being necessary or providing an answer. This is not because of our general antipathy towards 'red tape'. It is because we believe that regulation fails to get to grips with the real issue. The issue is primarily one of spreading best practice and improving the recruitment, selection, preparation, support and performance of non-executives.

What we would like to see is a clear statement of best practice covering the points listed in this document, along with the other aspects of board structure and operation. It would build on the Combined Code. It would also supersede the individual approaches to issues such as 'independence' being taken by different groups of investors, to the confusion and frustration of companies.

Companies should be required to report against these recommended guidelines; whilst they would not necessarily be obliged to follow every one, they would be obliged to point out and explain where they chose to deviate.

For this to work, three things are required.

First, there is a need to avoid more 'boiler plate' in Annual Reports, when what is wanted is concise and informative reporting.

Second, an intelligent response is needed from institutional shareholders: the current 'tick all the boxes or you don't get our vote' approach does very little to promote good governance, and if extended would do little to make non-executive directors more effective.

Third, the guidelines should be clear but not overly prescriptive in terms of detail. For example, the IoD welcomed the Secretary of State's proposal that companies should be prepared to explain their board remuneration policies and seek shareholder reaction. However, the way the proposal is being implemented obliges companies to produce comparisons (and implied criteria for determining performance) that we believe can be both inappropriate and misleading.

Moreover, any code of best practice needs to be kept continuously under review. Successive reviews in response to crises or public concerns need to be replaced by a process of continuous refinement. And since we are talking of best practice, it needs to be undertaken predominantly by practitioners.

Conclusion

In this submission we have given our views on the nature, and stressed the importance of the role of the non-executive director. We have also highlighted the extent of the commitment required, the limited financial reward, the extent of the liabilities involved and some of the difficulties in carrying out the role. One might justifiably ask why anyone would want to undertake the role and why we promote it so enthusiastically. The fact is that aside from being a key element of corporate governance, the non-executive role can be enormously stimulating and satisfying for the individual. It offers the chance to see a new company, perhaps a new industry, from a strategic position; it broadens the experience of even the most seasoned executive; it gives an opportunity to help shape the future of a business and feel part of its success.

We hope this current Review will lead to a clearer, and more widely shared, understanding of the role and to a progressive raising of standards.

The IoD greatly appreciates being asked to contribute to the Review and trusts that our views prove constructive. We would, of course, be prepared to discuss any of them in more depth.

For and on behalf of the Institute of Directors

A handwritten signature in black ink, appearing to read 'George Cox', with a stylized flourish at the end.

GEORGE COX
Director General

Acknowledgements

We would like to thank the many individuals who have contributed to the formulation of our response, in particular the following directors who have participated in our focus groups and surveys. In doing so, we should point out that although their views have played an important part in shaping our response, the opinions expressed in this document are those of the Institute and are not necessarily those of any individual.

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Philip Williamson
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