DIRECTORS' REMUNERATION

Report of a

Study Group

chaired by

Sir Richard Greenbury

17 July 1995

Contents

DIRECTORS' REMUNERATION
REPORT OF A STUDY GROUP CHAIRED BY SIR RICHARD GREENBURY

MEMBERS OF THE GROUP

CHAIRMAN'S PREFACE

REPORT

1.	INTRODUCTION	9
2.	CODE OF BEST PRACTICE	13
3.	MAIN ACTION POINTS	19
4.	REMUNERATION COMMITTEES	21
5.	DISCLOSURE	26
6.	REMUNERATION POLICY	34
7.	SERVICE CONTRACTS AND COMPENSATION	45
8.	PRIVATISED UTILITIES	49

APPENDICES

I	EXISTING DISCLOSURE REQUIREMENTS	53
II	ILLUSTRATIVE DISCLOSURE FORMATS	54
III	CONTRIBUTORS TO THE GROUP	57

STUDY GROUP ON DIRECTORS' REMUNERATION

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CHAIRMAN'S PREFACE

This Report responds to public and shareholder concerns about Directors' remuneration.

The key themes are accountability, responsibility, full disclosure, alignment of Director and shareholder interests, and improved company performance.

A group of leading investors and industrialists, meeting under my Chairmanship, has unanimously agreed a radical set of proposals embodied in a new Code of best practice.

I wish to thank members of the Group for all the time and wisdom they have contributed and the extent to which they have respected each others' views in reaching our conclusions. The Group is also indebted to KPMG, Freshfields, the Maitland Consultancy and Towers Perrin for providing professional support and to the many organisations and individuals who made submissions to us.

Acceptance of the Report's findings will lead to improved corporate remuneration practices. Accordingly the Group invites companies, investors, the Stock Exchange and the Government to implement these proposals.

Sir Richard Greenbury
Chairman

17 July 1995

1 INTRODUCTION

The Study Group

1.1 The Study Group on Directors' Remuneration was set up on the initiative of the CBI in January 1995 in response to public and shareholder concerns about the pay and other remuneration of company Directors in the United Kingdom. We have, however, operated independently of the CBI.

1.2 The Group's terms of reference were:

> "To identify good practice in determining Directors' remuneration and prepare a Code of such practice for use by UK PLCs."

1.3 The Group's work has focussed on PLC Directors. But much of the discussion applies equally to other senior executives.

1.4 Our work has also focussed on the larger listed companies whose remuneration packages have attracted most public attention. But the principles apply also to smaller listed companies. We hope that non-listed companies, too, will find our Report helpful.

1.5 The Group was grateful to receive advice from a wide variety of organisations, including companies, shareholder bodies, the TUC and from individuals. These have greatly assisted our deliberations.

Public and shareholder concerns

1.6 Recent concerns about executive remuneration have centred above all on some large pay increases and large gains from share options in the recently privatised utility industries. These increases have sometimes coincided with staff reductions, pay restraint for other staff and price increases.

1.7 There have also been concerns about the amounts of compensation paid to some departing Directors.

1.8 The publicity these cases have received has sparked some wider concerns about accountability for Directors' remuneration, especially in industries which operate in a less competitive environment.

Our own perceptions

1.9 In our view, UK companies mostly deal with Directors' remuneration in a sensible and responsible way. Much has been done in recent years to raise standards and improve procedures for this and other aspects of corporate governance. Specialist consultants have advised us that, for the most part, remuneration levels for Directors in the UK lie within the range of European practice and well below American levels.

1.10 We also believe there to be a key issue about performance which has received too little attention in the public discussion. The UK's industrial performance has greatly improved in recent years. It is vital that this improvement should continue. But the performance of our companies depends to an important extent on the Directors and senior executives who lead them. The remuneration packages UK companies offer must, therefore, be sufficient to attract, retain and motivate Directors and managers of the highest quality.

1.11 Nevertheless, we fully understand the concerns which shareholders, employees and the public have expressed in recent times about executive remuneration and compensation payments. There have been, in our view, mistakes and misjudgments.

1.12 We also accept that, since Boards of Directors face a potential conflict of interest when determining their own remuneration, there are important issues about accountability that need to be addressed.

The way forward

1.13 The way forward as we see it lies not in statutory controls, which would be at best unnecessary and at worst harmful, but in action to strengthen accountability and encourage enhanced performance. Such action should build on progress already made.

1.14 The key to strengthening accountability lies in proper allocation of responsibility for determining Directors' remuneration, proper reporting to shareholders and transparency. The specific requirements, as we see them, are:

- Boards of Directors need to delegate responsibility for determining executive remuneration to a group of people with a good knowledge of the company and responsive to shareholders' interests, but with no personal financial interest in the remuneration decisions they are taking.

- The same group of people needs to submit a full report to the shareholders each year explaining the company's approach to executive remuneration and providing full disclosure of all elements in the remuneration of individual Directors.

This is the approach which underlies the proposals in our Report for remuneration committees of Non-Executive Directors, annual reports to shareholders and full disclosure.

1.15 The key to encouraging enhanced performance by Directors lies in remuneration packages which:

- link rewards to performance, by both company and individual; and

- align the interests of Directors and shareholders in promoting the company's progress.

1.16 In our view these fundamental principles of accountability, transparency and performance, and the related

arrangements and procedures, need to be encapsulated in a new Code of best practice on Directors' remuneration which companies will observe and implement. The new Code should subsume and replace the considerable number of existing codes and guidance notes on the subject.

1.17 Our proposed Code is in section 2. Section 3 contains our recommendations for action. Sections 4 to 7 elaborate and discuss the Code. Section 8 discusses its application to the privatised energy and water companies.

1.18 We propose that all listed companies registered in the UK, and others too as they see fit, should comply with the Code and report annually to shareholders about their compliance with it, as provided in section 2, paragraph 2.3.

1.19 We ask the London Stock Exchange and the investor institutions to use their powers and influence to ensure that this happens. Our specific proposals are in section 2, paragraph 2.4 and section 3, paragraph 3.4.

3 MAIN ACTION POINTS

3.1 The Code of best practice in section 2 summarises our substantive recommendations on setting Directors' remuneration. Our recommendations for action are as follows.

Companies

3.2 All listed companies in the UK should comply with the Code to the fullest extent practicable. They should make an annual compliance statement to shareholders as provided in section 2, paragraph 2.3.

London Stock Exchange

3.3 The London Stock Exchange should introduce continuing obligations for listed companies to implement the Code's provisions as set out in section 2, paragraph 2.4.

Investor institutions

3.4 The investor institutions should use their power and influence to ensure the implementation of best practice as set out in the Code.

Faculty and Institute of Actuaries

3.5 The Faculty of Actuaries and the Institute of Actuaries are invited to make recommendations as soon as practicable on the method to be used to calculate the value of pension entitlements earned by individual Directors during the year (paragraph 5.21).

Privatised utilities

3.6 The privatised water and energy companies should review comprehensively their existing remuneration packages in the light of this Report, adjust them on a voluntary basis as necessary and make a full report to shareholders for discussion at the first available AGM (paragraphs 8.11 – 8.12).

3.7 For any newly privatised companies, no share option grants should be made until at least six months, and preferably a year or more, after privatisation (paragraph 8.9).

The Government

3.8 Gains from executive share options should in future be taxed as income rather than capital gains. The Government should bring forward the necessary amendments to the tax legislation (paragraph 6.36).

3.9 The Government should bring forward secondary legislation under the Companies Act 1985 to remove from companies which make full disclosure of their Directors' remuneration the obligation to show it in £5,000 bands (paragraph 5.11).

3.10 The Government should review the present Companies Act requirements for disclosure of information on Directors' pensions as soon as the alternative approach we recommend is in place and companies are able to make the new form of disclosure (paragraph 5.22).

Successor Committee

3.11 The new Committee which is to succeed the Committee on the Financial Aspects of Corporate Governance should also act, as necessary, as successor to our Committee and should monitor responses to our Committee's recommendations.

4 REMUNERATION COMMITTEES

4.1 This section discusses and elaborates section A of the Code.

Previous guidance

4.2 There already exists a considerable amount of guidance on remuneration committees published by ProNed, the ABI, the NAPF, the Committee on the Financial Aspects of Corporate Governance, the Institute of Directors and others. Our own Code is intended to subsume and replace this earlier guidance.

Role

4.3 It is a well-established principle of corporate governance in the UK that Boards of Directors are responsible and accountable to shareholders for all aspects of a company's affairs. As discussed in section 1, however, they cannot decide the remuneration of their own members without potential conflict of interest. The solution which many UK and American companies, in particular, have developed is to set up remuneration committees of Non-Executive Directors with no personal financial interests at stake to decide executive remuneration on their behalf and account directly to the shareholders for their decisions while promoting the wider interests of the company. Companies may need to change their Articles of Association to facilitate this.

Terms of reference

4.4 Boards should develop clear terms of reference for their remuneration committees. These should require the committee:

- to determine on behalf of the Board and the shareholders the company's broad policy for executive remuneration and the entire individual remuneration packages for each of the Executive Directors and, as appropriate, other senior executives.

- in doing so, to give the Executive Directors every encouragement to enhance the company's performance and to ensure that they are fairly, but responsibly, rewarded for their individual contributions;

- to comply with our Code of best practice;

- to report and account directly to the shareholders, on the Board's behalf, for their decisions.

4.5 Remuneration committees' first concern should be with the remuneration of the Executive Directors. However, their remit may need to extend to other senior executives in the company even if they are not formally Executive Directors.

Establishment of committees

4.6 Most listed companies have already established remuneration committees. Those which have not should establish them now or explain in their next annual report why they have not done so and what alternative arrangements they have made.

Status and election

4.7 Remuneration committees should be constituted as sub-committees of the Board of Directors with a special responsibility to discharge, on behalf of the Board, certain functions which the Board itself should not discharge. The Board should elect both the Chairman and the members.

Membership and qualifications

4.8 The remuneration committee should consist exclusively of Non-Executive Directors with relevant experience who:

- have no personal financial interest, other than as shareholders, in the committee's decisions;

- have no "cross-directorships" with the Executive Directors which could be thought to offer scope for

mutual agreements to bid up each others' remuneration;

- have a good knowledge of the company and its Executive Directors, a keen interest in its progress and a full understanding of shareholders' concerns; and
- have a good understanding, enhanced as necessary by appropriate training or access to expert advice, of the areas of remuneration committee business.

4.9 The Non-Executive Chairman of a company should not act as Chairman of the remuneration committee if he or she is involved in the day-to-day running of the company or his or her own remuneration arrangements would involve any conflict of interest.

4.10 It is sometimes suggested that remuneration committees should include one or more independent members not associated with the company's Board or management. In our view, this would be wrong. The Board must be responsible for all aspects of a company's affairs. In addition, the people responsible for determining the remuneration of the Executive Directors need to have, among other things, a good knowledge of the company and its Executive Directors and to be well placed to assess their individual contributions. People whose sole connection with the company is as members of the remuneration committee cannot realistically fulfil these conditions.

Size

4.11 The remuneration committee should consist of at least three Non-Executive Directors (at least two in the case of small companies). If this is not practicable, the remuneration committee's report to shareholders should explain why.

Terms of office

4.12 Since knowledge and experience are important, remuneration committee members should preferably serve for a period of at least three years, subject to the normal periodic re-election of Directors. Where Directors stand for re-election, the proxy cards should indicate their specific duties, including membership of the remuneration or other committees.

Remuneration

4.13 To ensure that remuneration committee members have no personal financial interest in the remuneration arrangements they decide for the Executive Directors, their own remuneration should normally take the form of fixed fees set by the Board as a whole within the limits set in the Articles of Association, reflecting the amount of time they give to the company's affairs. Non-Executive Directors should abstain from any discussion or decisions relating to their own remuneration which should be reported to shareholders along with that of the Executive Directors.

Support for the committee

4.14 Although Executive Directors should not be members of the remuneration committee, the company's Chairman and/or Chief Executive should normally be invited to attend meetings to discuss the performance of the other Executive Directors and make proposals as necessary. The committee may wish to consult the other Non-Executive Directors in its evaluation of the Chief Executive.

4.15 The committee should also be supported by a senior executive of the company with suitable expertise and independent access to the committee Chairman.

4.16 The committee should have access to reliable, up-to-date information about remuneration in other companies and should judge the implications carefully. The full disclosure we advocate in this report will itself provide more accessible data.

4.17 The committee may need to draw on outside advice. This should combine quality and judgement with independence. The company's management will normally hire outside consultants, if any, but the committee should be consulted about such appointments and should be free to retain its own consultants in case of need.

5 DISCLOSURE

5.1 This section elaborates and discusses section B of the Code of best practice.

Full disclosure

5.2 We attach the highest importance to full disclosure of Directors' remuneration as a means of ensuring accountability to shareholders and reassuring the public. Existing disclosure requirements, summarised in Appendix I, are not sufficient.

5.3 Full disclosure does not mean swamping shareholders with a mass of detail in which the essential points risk being lost. The important point is rather that companies and their remuneration committees should adopt a new philosophy of full transparency such that shareholders have access to all the information they may reasonably require to enable them to assess the company's general policy on executive remuneration and the entire remuneration packages of individual Directors.

Annual report to shareholders

5.4 The annual remuneration committee report to shareholders should be the main vehicle through which the company discloses and accounts to shareholders for Directors' remuneration. The report should be made on behalf of the Board. It should form a separate section within, or annexed to, the company's annual report and accounts. It should set out both the company's general policy on executive remuneration and the actual remuneration packages, including share options and pension entitlements earned, of the individual Directors by name. The amounts received by, and committed to, each Director should be subject to audit.

Disclosure of general policy

5.5 The section on general policy should set out the company's policy on major issues such as:

- the total level of remuneration;
- the main components and the arrangements for determining them, including the division between basic and performance-related components;
- the comparator groups of companies considered;
- the main parameters and rationale for any annual bonus schemes, including caps;
- the main parameters and rationale for any share option or other long-term incentive schemes;
- how performance is measured, how rewards are related to it, how the performance measures relate to longer-term company objectives and how the company has performed over time relative to comparator companies;
- the company's policy on allowing Executive Directors to accept appointments and retain payments from sources outside the company;
- the company's policy on contracts of service and early termination (*see* section 7);
- the pension and retirement benefit schemes for Directors, including the type of scheme, the main terms and parameters, what elements of remuneration are pensionable, how the Inland Revenue pensions cap has been accommodated and whether the scheme is part of, or separate from, the main company scheme.

5.6 Attention should be drawn to any special arrangements made and any material changes introduced during the year.

5.7 The above provisions apply to the Executive Directors. The report should also state how, and by whom, the fees and other benefits of the Non-Executive Directors are determined.

Disclosure of individual Directors' remuneration

5.8 The section on individual Directors' remuneration should detail all elements in the packages of each individual Director by name, including Directors based wholly or mainly overseas. These details should cover basic salary, the nature and value of benefits in kind, annual bonuses, and long-term incentive schemes including share options. Also included, as soon as practicable, should be the value of pension and other benefit entitlements earned by individual Directors during the year less any contributions they have made.

5.9 The extent to which performance criteria have been met should be explained, as should any particular performance criteria on which individual Directors' entitlements depend and any special arrangements made for them.

5.10 Also disclosed should be any payments and benefits not previously disclosed, including any additional pension provisions, receivable by Directors who have retired during the accounting period or the previous accounting period.

5.11 The Government should bring forward secondary legislation under the Companies Act 1985 to remove from companies which make full disclosure of their individual Directors' remuneration the obligation to show it in £5,000 bands.

5.12 The tables in Appendix II illustrate a possible format for disclosure of individual Directors' remuneration.

Disclosure of share options

5.13 The Accounting Standards Board's Urgent Issues Task Force (UITF) concluded in 1994 that it is not practicable at present to specify a standard method for valuing share option schemes. Full details of each individual Director's entitlements will therefore need to be disclosed in accordance with the Task Force's Abstract 10 (and its successors):

- the number of shares under option at the beginning of the year (or date of issue if later) as well as at the end;

- the number of options granted, exercised and lapsed unexercised during the year;
- the exercise prices of all options;
- the dates from which the options may be exercised and the expiry dates;
- the cost of the options (if any);
- the market price of the shares at the date of exercise for options exercised during the year; and
- a summary of any performance criteria on which exercise of the options is conditional.

5.14 In the disclosure of share option details there is some risk that the abundance of information will mask rather than highlight the nature and scale of the option schemes. Remuneration committees may wish, therefore, to consider the more concise disclosure models also described by the UITF, including the weighted average subscription price method, provided that they are satisfied that this will not result in failure to disclose information of material importance.

5.15 The UITF guidelines also require disclosure of the market price at the end of the year of shares granted under an option scheme, together with the range during the year (high and low).

5.16 Other features of share option schemes which are of material importance should also be disclosed.

Disclosure of pension entitlements

5.17 Pension entitlements, and in particular the value of a Director's pension entitlements earned during the year, are an important element within total remuneration and should, in principle, be disclosed along with other elements of remuneration.

5.18 The information on employer contributions which companies are presently obliged to disclose fails in many cases to capture the true worth to the individual, or the true cost to the company, of pension entitlements. Pension schemes where the employer is making no contribution, such as unfunded schemes or schemes presently on a contributions holiday, can be valuable to the Director, and costly to the company, in the longer term. Similarly, pay increases shortly before retirement can greatly affect the value to the Director and the longer-term cost to the company of a Director's pension rights. Changes in employer contributions may not adequately capture these consequences.

5.19 For defined benefit schemes, such as those which link pension entitlement to final or best year's salary, the pensions element in a Director's remuneration is best measured as the present value of pension entitlement earned during the year resulting from additional length of service, increases in salary or changes in the terms of the scheme, less any contributions made by the Director during the year. For such schemes, therefore, remuneration committees' annual reports should disclose, as soon as practicable, the present value of the extra pension entitlement earned during the year, defined in this way, for each individual Director by name. Any major changes compared with the previous year should be explained.

5.20 For defined contribution (money purchase) schemes, and in cases where the Director receives an allowance in lieu of membership of a pension scheme, the contribution or allowance paid by the company will measure correctly the value to the individual and the cost to the company. The remuneration committee report should therefore disclose the amounts paid by the company to, or in respect of, the Director.

5.21 There is a technical issue as to how pension entitlements earned over the year under defined benefit schemes should be valued. The Faculty of Actuaries and the Institute of Actuaries have agreed to advise on this as soon as practicable so that companies can adopt this new form of disclosure at the earliest opportunity.

5.22 When the technical issue has been resolved and companies are making the new form of disclosure we propose, we recommend that the Government should review the present statutory requirements for disclosure of pensions information.

5.23 In the meantime, companies should continue with present forms of disclosure. They should, however, also disclose any unfunded promises or other pension arrangements that create a future liability and any special features of an individual Director's entitlements, including any changes during the year, which differ from the general Directors' or company scheme.

Directors' shareholdings

5.24 The Companies Act 1985 and the London Stock Exchange Listing Rules require disclosure of the interests of each Director (including interests held by their spouse or infant children) in shares and debentures of the company. We do not suggest any change in these provisions.

Other matters for disclosure

5.25 The remuneration committee's annual report to the shareholders should list the members of the committee. It should also include the statement about compliance, and the explanation and justification for any areas of non-compliance, provided for in paragraph 2.3.

Shareholder communications and approval

5.26 The Code of best practice provides that the remuneration committee's annual report to the shareholders should form a self-contained part of, or be annexed to, the company's annual report and accounts and thus be laid before the company's AGM.

5.27 The Code also provides that the remuneration committee Chairman should attend the AGM to answer questions about Directors' remuneration, including any matters arising from the report; and should ensure that the company maintains

good contact with the major shareholders about remuneration in the same way as for other matters.

5.28 We have considered whether the shareholders at the AGM should be invited to approve the policy set out in the remuneration committee's report (though not the detailed figures for each Director) or to signify in some other way their concurrence in this aspect of the company's policies. The Board could, for example, put down each year a resolution approving the policy in the report and the meeting could be invited to vote on this resolution.

5.29 We do not think that the remuneration committee's report should be a standard item of agenda for AGMs. We doubt there is any need to arrange a vote every year on this area of business as opposed to others. For the AGMs of most companies in most years, the key issues will be the company's progress and competitive position and the Board's overall stewardship rather than the remuneration committee's report.

5.30 If shareholders do have concerns about the Directors' remuneration, they have the options of speaking at the AGM to make their concerns known or putting down their own resolutions for the AGM (subject to meeting the relevant thresholds), or voting against remuneration committee members standing for re-election or, in extremis, voting against the annual report and accounts.

5.31 We also think, however, that Boards of Directors and remuneration committees should feel free to put down a resolution approving the policy in the committee's report if they believe that there are special circumstances which make this appropriate. If, for example, a company wishes to change radically its remuneration policies, or if its policies in this area have attracted controversy, the Board and the remuneration committee may think it right to seek explicit backing in this way from the shareholders.

5.32 The Code provides accordingly that the remuneration committee's annual report should not be a standard item of agenda for AGMs. But the committee should consider each

year whether the circumstances are such that shareholders should be invited to approve the policy set out in their report and should minute their conclusions.

5.33 Shareholders should, however, be invited to approve all long-term incentive schemes available to Directors and senior executives, whether payable in cash or shares, and not just share option schemes. Long-term incentive schemes differ from annual bonuses in that they relate to performance over a run of years and potentially commit shareholders' funds for more than one year ahead, or dilute the equity.

6 REMUNERATION POLICY

6.1 This section elaborates and discusses section C of the Code of best practice.

Market forces and discretion

6.2 There is a market in executive talent. Market forces are especially apparent in certain industries, notably international industries, and in certain skills. There are also market-related lower limits for the remuneration of Directors and senior executives in the largest companies. Below these limits companies would have great difficulty in recruiting, retaining or motivating people of the right quality and experience.

6.3 However, the market is imperfect. Many Directors and senior executives spend much or all of their working lives with the same organisation. The remuneration they receive is determined by Boards or remuneration committees rather than directly by the market. These committees are often influenced by consultant surveys or information exchanges with other companies. However, there remains much scope for different interpretations and applications.

6.4 While market forces set a broad framework, therefore, remuneration committees for the most part have quite a wide range of discretion in setting levels and forms of remuneration. Their task is not easy. It requires knowledge and judgement.

Levels

6.5 The two key principles which need to inform decisions on levels of executive remuneration are:

- Boards and remuneration committees must have flexibility to offer the packages required to attract, retain and motivate people of the calibre and experience they need to make their companies successful;

- Companies should, however, be careful to avoid paying more than is required for this purpose.

6.6 Both principles are important. High levels of remuneration are justified where circumstances require it or contributions to company performance are outstanding. Inspired direction of a company can make all the difference between success and failure. Inadequate direction and management will lead to poor performance from which shareholders, employees and customers will all suffer.

6.7 Paying over the odds, on the other hand, is incompatible with the fiduciary duty of Directors to act in the company's best interests. It can spread through normal differentials to other levels in the company, thus increasing the cost base and impairing the company's ability to compete. It can cause resentment among staff and damage the company's reputation.

6.8 Within these principles, remuneration committees need to consider carefully a range of issues such as their overall strategy for executive remuneration levels; the positioning of their company relative to other companies; the group of companies, if any, with which their company should be compared; the surveys and other information they need and the reliability of this information; the equivalent levels of jobs between their company and others; and remuneration relativities inside the company, especially between the Directors and other senior executives.

International perspective

6.9 As discussed in section 1, remuneration levels for Directors in the UK appear, for the most part, to lie within the range of European practice and well below American levels. The international comparisons do not suggest, therefore, that UK companies in general pay their senior executives too much, though the overall position may mask occasional excesses.

6.10 Companies in the rest of Europe generally disclose much less information about Directors' remuneration than UK companies. This makes comparisons difficult. However, the specialists we have consulted have concurred in describing the broad picture as follows:

- For the largest companies, total remuneration levels in the UK appear broadly comparable with other European countries and well below American levels. There are, however, marked differences in composition. In the United States, for example, performance-related elements account for a high proportion of the total. In Germany and Italy, share option and long-term incentive schemes are rare. The UK and France lie somewhere in between.

- For medium-sized and smaller companies, there is no evidence to suggest that, in general, executive remuneration levels in the UK are excessive compared with other countries.

- Contrary to what is sometimes suggested, pay differentials between Directors and employees in the UK appear generally to be around the average for European countries and indeed for industrial countries as a whole.

- Retirement benefits in the UK, typically providing two-thirds of final salary, are towards the upper end of the 50 to 70 per cent range of international practice. However, pensions are normally based on salary alone which accounts for a lower proportion of total remuneration in the UK than in most other countries.

Positioning

6.11 In considering the positioning of their company relative to other companies, Boards and remuneration committees should consider not only the company's relative size but also other factors such as recruitment and retention difficulties; the behaviour of others in the sector; the competition the company faces; the risks, challenges, complexity, diversity

and international spread of the business; and the special expertise and understanding required of its executives. They should bear in mind that any chosen comparator group may be less than fully comparable and may not provide good examples to emulate.

6.12 Companies should not pay above average levels regardless of performance. They should also beware of basing remuneration levels on a skewed comparator group so as to justify higher remuneration levels. If companies generally pursue such policies, the effect will simply be to ratchet up the general level of executive remuneration. Remuneration committees' annual reports to shareholders should disclose and justify any deliberate policy of paying above the average.

Sensitivity

6.13 Remuneration committees should be sensitive to the wider scene, in particular pay and employment conditions elsewhere in the company, so that their decisions may, as far as possible, be consistent and fair, and be seen as such.

Components

6.14 The remuneration packages of Executive Directors in the UK usually include some or all of the following elements:

- basic salary
- benefits in kind
- annual bonus
- share options
- other long-term incentive schemes
- pension rights.

6.15 Remuneration committees need to consider how remuneration should be divided between the "fixed" elements of basic salary, benefits in kind and pension rights, which Directors will receive regardless of the company's performance, and "variable" or "performance-related" elements such as annual bonuses, share options and other long-term incentive schemes, whose value will vary with the performance of the company or group.

6.16 A key concern should be to ensure, through the remuneration system, that Directors share the interest of shareholders in making the company successful. Performance-related remuneration can be highly effective in aligning interests in this way. In many companies, therefore, there will be a case for a high gearing of performance-related to fixed pay. But there are two constraints on this. First, there will usually be a level of basic salary below which it will not be practicable to go. Second, the requirements and priorities of companies vary. The gearing which suits one company may be quite unsuitable for another.

Basic salary

6.17 In setting a basic salary level for each Director's job, the following considerations will be relevant:

- the range of rates for similar jobs, based on comparator company information;
- individual performance, which is likely to reflect skills, experience and judgement as well as commitment;
- internal company relativities; and
- risks, job-security and particular circumstances in relation to the individual.

Benefits in kind

6.18 In some companies, and for some Directors, the value of benefits in kind can be considerable. Remuneration committees should not only be aware of how much these are worth but should also keep them under review.

Annual bonuses

6.19 Remuneration committees need to consider whether Directors and other senior executives should be eligible for annual bonuses. There are some who argue that the Chief Executive and Directors should concentrate on longer-term company performance, not short-term indicators. But bonuses can be a valuable instrument of management. They can be used flexibly to encourage and reward an aspect of performance that is different from that encouraged by long-term incentive schemes but still relevant and important. The balance of considerations is likely to vary from company to company.

6.20 The size of the annual bonus usually reflects company performance against targets for some financial yardsticks such as profits, cash flow, or earnings per share, or operational yardsticks such as quality or customer service. These targets should always be relevant, stretching and designed to enhance the business. They should relate to what individuals can influence and what is important for the company.

6.21 Bonuses should not be allowed to become, in effect, another guaranteed element of remuneration. They should normally be subject to an upper limit or cap, such as a specified percentage of basic pay. However, the scale of bonus schemes needs to be considered alongside basic salary levels to ensure that the likely total level of remuneration is appropriate.

6.22 There is a case for requiring that some proportion at least of any bonuses paid to Directors should take the form of shares to be held for a minimum period rather than cash. In setting

this proportion, allowance should be made for the recipient's liability to pay tax on the bonus.

Long-term incentive schemes including share options

6.23 Remuneration committees should consider whether share options or other forms of long-term incentive scheme will help to promote company and shareholder interests and, if so, what form they should take.

6.24 Executive share options are the longest established long-term incentive schemes. The basis of such schemes is that the company grants options to its executives to buy a given number of shares in the company at or after some future date, not at the price then prevailing, but at (or up to 15 per cent below) the price at the time the option was granted. The latter price is known as the exercise price. Provided that the exercise price discount does not exceed 15 per cent, and subject to certain other qualifications, Inland Revenue rules allow gains from the exercise of executive options to be taxed as capital gains when the shares are sold instead of being immediately taxed as income on exercise.

6.25 Directors exercising options typically dispose of most or all of the shares so as to fund the original purchase of the shares and any tax due. The reward they receive reflects the gain resulting from any increase in the share price above the exercise price, less tax.

6.26 Under the London Stock Exchange Listing Rules, any schemes involving the issue of new shares are subject to approval by shareholders in a general meeting. There are also guidelines issued by the Investment Committees of the ABI and the NAPF which limit the total proportion of a company's shares that may be made available for share option and other schemes.

6.27 Share option schemes give Directors a personal financial interest in seeing the share price rise, thus helping to align the interests of Directors and shareholders. In principle, they enable Directors to build up holdings of shares in the company. For the time being, they continue to offer tax

advantages, albeit now reduced. They may be attractive to smaller companies as being more affordable in the short term than other forms of remuneration. They may also be helpful in recruiting new Directors from abroad or based abroad.

6.28 However, these schemes, at least in their traditional form, also have drawbacks. Depending as they do on changes in the share price between two points of time, they may confer on Directors windfall gains that have nothing to do with their own efforts but reflect exercise price discounts, general price inflation, general movements in share prices or movements in the share prices of a whole sector. In addition, Directors generally have not been induced to build up substantial shareholdings in their companies if only because they have instantaneously to sell many of the shares they acquire in order to finance their purchase.

6.29 To reduce freak results from share price fluctuations, grants of share options should normally be phased over time rather than made in one large block. Executive share options should never be issued at a discount.

6.30 Companies can improve further, and in some cases have already improved, share option schemes by making exercise of the options conditional on challenging performance criteria along the lines described below. All new schemes should be subject to such criteria. Companies should also introduce such criteria, and the other improvements discussed in this section, wherever possible for future grants under existing schemes.

6.31 The other forms of long-term incentive scheme which should be weighed against share option schemes typically reward Directors with a predetermined number of shares or cash amounts, rather than share options, if certain challenging performance criteria are fulfilled over various periods of time, subject to their holding the shares for a substantial period. Some companies are already introducing such schemes.

6.32 Schemes along these lines may be as effective, or more so, than improved share option schemes in linking rewards to performance, encouraging Directors to build up

shareholdings in their companies, and thus in aligning the interests of Directors and shareholders.

6.33 All long-term incentive schemes involve potential commitments of shareholders' money at some future date or dilution of the company's equity. Hence our earlier recommendation that all such schemes, whether or not involving the issue of shares, should be subject to approval by the shareholders in a general meeting. The Code (B12) provides for this.

6.34 A further provision in the Code, C6, is that in normal circumstances shares granted should not vest, and options should not be exercisable, within three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and any associated tax liability.

6.35 The Code also provides, at C7, that any new long-term incentive schemes which are proposed should preferably replace existing schemes or at least form part of a coherent overall plan incorporating existing schemes. Remuneration committees should ensure that the total rewards available are not excessive. New schemes should not be added automatically to existing schemes. When proposals for new plans or schemes are laid before shareholders a full explanation should be given of what schemes they will replace and how they will fit in with any continuing schemes.

6.36 There is no good reason why executive share option schemes should receive favoured tax treatment compared with other forms of long-term incentive scheme. Neither is there any obvious reason why executive share option schemes should receive favourable tax treatment at all. We therefore recommend that gains from executive share options should, in future, be taxed as income at the time of exercise rather than capital gains on disposal. The Government is invited to bring forward the necessary amendments to the tax legislation.

6.37 We emphasise that these proposals relate to executive share option schemes and not to SAYE or other schemes available to all or substantially all employees.

Performance criteria

6.38 The purpose of long-term incentive schemes is to encourage continuing improvement in performance over time. That is why rewards under all such schemes should be subject to challenging performance criteria.

6.39 In considering what the performance criteria should be, remuneration committees should consider criteria which measure company performance relative to a group of comparator companies in some variable, or set of variables, reflecting the company's objectives such as total shareholder return. (However, there are a range of possible measures). Directors should not be rewarded for increases in share prices or other indicators which reflect general price inflation, general movements in the stock market, movements in a particular sector of the market or the development of regulatory regimes.

6.40 In this, as in other areas, the final decision should depend on the company's particular circumstances.

Shareholdings

6.41 Remuneration committees should continue to encourage Directors to acquire and retain significant shareholdings in their company so as to reinforce alignment of the interests of Directors and shareholders.

Pension entitlements

6.42 For Directors, as for others, pension entitlements are a key element in total remuneration, with important longer-term implications for the individual and the company. Remuneration committees, therefore, need to consider carefully pension provision and to take professional advice on how best to deal with the many strategic and technical issues, including types of scheme and the Inland Revenue cap.

6.43 As discussed in section 5, the pension element in remuneration needs to be measured in terms of the value of pension entitlements earned during the year.

6.44 Remuneration committees need to consider what elements in remuneration should be pensionable. Basic salary should be pensionable. Annual bonuses are a management instrument designed to promote and reward short-term performance. In general neither they nor payments under long-term incentive schemes nor benefits in kind should be pensionable. If such elements are pensionable, the remuneration committee report should explain and justify why.

6.45 Where pension entitlements are based, as most company schemes are, on final salary, or average salary over a best period of years, large increases in basic salary towards the end of a career will be reflected in a correspondingly proportionate increase in pension entitlement which will not only represent a great benefit to the individual but will also be disproportionately costly for the pension fund and hence ultimately the company. This, too, is a matter which remuneration committees need to watch carefully.

7 SERVICE CONTRACTS AND COMPENSATION

7.1 This section elaborates and discusses section D of the Code of best practice.

The issue

7.2 Compensation payments to Directors on loss of office have been a cause of public and shareholder concern in recent times. Criticism has been directed at the scale of some of the payments made and at their apparent lack of justification in terms of performance. Some payments have been described as "rewards for failure".

7.3 Companies have statutory and contractual obligations to Directors whose contracts are breached through early termination. In practice, the terms of the Director's contract of service with the company are almost always the decisive element in determining his or her entitlement to damages.

7.4 Most Directors in the UK have "rolling" service contracts providing for a specified period of notice of termination. In the past such periods of notice have generally been three years but in response to guidelines from the investor institutions many companies have brought (or are bringing) the period down to two years or less.

7.5 With a contract incorporating a notice period of, for example, two years, the company has an obligation to pay damages of up to two years' pay on breach of contract through early termination. The departing Director is, however, obliged under common law to use reasonable efforts to reduce or "mitigate" the amount of compensation required by finding a new source of earnings. An assumed amount of "mitigation" is invariably built into the negotiated compensation sum.

7.6 Some contracts provide for pre-determined amounts of compensation, known as "liquidated damages", in the event of early termination. In such cases the amount of

compensation payable will have been negotiated at the outset and there will be no need for a further negotiation at the time of termination.

7.7 Another category of contracts provides for a fixed term of service, such as three years, without any notice period. In such cases the employer's contractual obligation will be to pay the departing Director for the unexpired portion of the contract less any deduction for mitigation.

7.8 The maximum amounts of compensation depend, therefore, on the notice or contract period, according to the type of contract, except when the amount is predetermined. Under the Companies Act 1985, companies are not permitted to pay in excess of these amounts, less mitigation, without shareholder approval.

7.9 However, there are areas of flexibility. Companies can decide how long to retain a Director before his or her departure. There is flexibility, too, over the reductions negotiated for "mitigation" and companies have the option, in deserving cases, of paying more than the mitigated damages due provided that they obtain shareholder approval.

Policy on contracts

7.10 Remuneration committees should consider carefully what compensation commitments their Directors' contracts of service would entail in the event of early termination, particularly for unsatisfactory performance.

7.11 As discussed above, the notice or contract periods establish the maximum compensation payable in the absence of pre-determined compensation terms. The most effective way to avoid large payments is therefore to shorten these periods, as many companies have done, as well as maximising flexibility in contracts.

7.12 For the future, some argue that notice or contract periods should be limited to one year or less; others argue for a limit of two years.

7.13 The Code states that there is a strong case for setting notice or contract periods at, or reducing them to, one year or less. The annual remuneration report to shareholders should disclose any contracts with periods over one year and explain why they are considered appropriate.

7.14 Companies do need, however, to be sensitive and show flexibility, especially over timing. Abrupt moves to curtail Directors' contract lengths could damage morale in some companies. There could be costs in some cases. The interaction with contract terms below Board level also needs to be considered.

7.15 For some companies, therefore, notice or contract periods of between one and two years, or equivalent amounts in liquidated damages, may be acceptable. Longer periods should be avoided wherever possible. Liquidated damages provisions should be pitched on the low side to allow for mitigation and the greater certainty the Director has.

7.16 In some areas companies may need still further flexibility. It may be necessary to offer longer initial contract periods in order to recruit new Directors from outside or to reflect local practice on relocation. Contracts for new Directors from outside, for example, might need to provide for an initial fixed term of up to three years, reducing thereafter.

Policy in individual cases

7.17 Within the contractual constraints, remuneration committees should tailor their approach in individual early termination cases to the wide variety of differing circumstances. At one extreme, a departing Director may have let the company down badly. At the other, there may be no question of poor performance. The company may need only one Finance Director rather than two after a merger.

7.18 The broad aim should be to avoid rewarding poor performance whilst dealing fairly with those whose departure has little or nothing to do with poor performance.

The actual terms will usually need to be negotiated. They will need to take account of the reasons for termination, the contractual terms and mitigation. Wherever possible, departures should be amicable; public disputes can be damaging. It may also be important to reach agreement with departing Directors that they will not work against the company after leaving.

7.19 Remuneration committees should take a robust line on payment of compensation where performance has been unsatisfactory. It will often be difficult to establish criteria against which to judge performance, but such criteria, or previously documented warnings about performance, may help in negotiating compensation in such cases.

7.20 Remuneration committees should also take a robust line on mitigating compensation. Departing Directors have an obligation to mitigate loss. Companies should ensure that this is adequately reflected in settlement terms. They should also consider phasing compensation payments over a period and reducing or stopping them when the departing Director takes a new job. Mitigation then becomes automatic. The shorter the notice periods are, the less significant the issue of mitigation will be.

8 PRIVATISED UTILITIES

Issues

8.1 The levels of pay and the potential gains from share options in some of the recently privatised utility companies have attracted a great deal of comment and criticism. The factors that have attracted most attention are:

- large increases in the salaries of Directors immediately following privatisation, where the roles have seen little change and the incumbents have, in many cases, remained the same;
- salary increases for Directors coinciding with reductions in pay or job opportunities for employees;
- the immediate award of share options before share prices have stabilised following privatisation.

8.2 There is a widespread perception among members of the public, as customers, that these industries should continue to recognise a significant element of public accountability for the way they conduct their affairs, especially where their customers have no choice of service provision.

8.3 Whatever view may be taken about the precise extent of public accountability, there is little doubt that the remuneration committees of a number of companies in the privatised water and energy sectors have developed, perhaps unintentionally, remuneration packages that are richer than is required to recruit, retain and motivate quality managers. The richness lies in the combination of salary levels and share options.

8.4 Some remuneration committees have also seemed insensitive to the opinions of the company's other stakeholders and have misjudged the timing of their decisions and announcements.

Possible responses

8.5 In principle, the determination of Executive Directors' remuneration in privatised utility companies should be no different from that in other companies. Remuneration should be set so as to attract, retain and motivate quality managers.

8.6 In judging what this means in practice, remuneration committees in the privatised utilities need to take a rounded view of the markets in which they operate and the marketability of their Directors. Remuneration should be linked to the complexity and challenge of the roles and to the performance of the Executive Directors within them. The size of the company is unlikely to be the single most important determinant of the appropriate salary level. The qualities required of an Executive Director are more demanding, and should command a greater premium, where:

- there is substantial competition and risk;
- a wide diversity of activities is undertaken and there is an international spread of operations;
- significant technological or structural change is under way.

Few of the recently privatised utilities score highly on these criteria.

8.7 There is also a strong case for linking rewards to a company's performance compared with others in the sector and not rewarding Directors for sector-wide share price increases which have little to do with their own efforts.

8.8 Share options in privatised companies pose particular difficulties in this respect. Share prices can change significantly in the aftermath of privatisation for reasons that have little or nothing to do with the performance of management. Significant short-term gains have been common and the development of the regulatory regime can

have profound effects subsequently on profits and share prices. Some privatised companies have been at the forefront of good practice in this area, waiting until the share price has stabilised before granting options and phasing their introduction thereafter whilst others have been less sensitive. Many made grants within a month of privatisation, while some have also introduced discounted schemes inviting criticism for windfall gains.

Future privatisations

8.9 For future privatisations the lessons from the past, as described above, can be readily applied. Remuneration committees of the remaining candidates for privatisation will clearly need to pay attention to what is truly required to attract, retain and motivate quality managers; to consider the case for long-term incentive schemes; to weigh the merits of share options against other forms of scheme; to set performance criteria which emphasise performance relative to other similar companies and do not provide rewards for general market movements; to establish a time gap of no less than six months, and preferably a year or more, between flotation and the grant of share options or the introduction of similar schemes; to phase in any such options; and to show sensitivity to other stakeholders' opinions. The approaches they propose should be subject to shareholder scrutiny through the reports of their remuneration committee Chairmen to their first AGMs.

Existing privatised utilities

8.10 For the existing privatised utilities, the question is whether they should take retrospective action in cases where there may have been windfall gains on share options or where insufficient attention may have been paid to the indicative criteria discussed above for establishing remuneration levels. Some of the privatised companies, to their credit, have already taken steps to redress the balance where the decisions of their remuneration committees have led to a richness of reward that may not have been intended or has proved unjustifiable.

8.11 We strongly recommend that all the privatised utilities in the water and energy sectors should undertake a comprehensive review of their remuneration packages in the light of this Report and, if necessary, voluntarily adjust them accordingly.

8.12 The outcome of the reviews, which should explain and justify all elements of the remuneration package, whether adjusted or not, should be reported to shareholders as soon as possible, for discussion at the first available AGM. Institutional, as well as individual, shareholders should be encouraged to take an active interest in these reviews.

APPENDIX I

EXISTING DISCLOSURE REQUIREMENTS

The Companies Act 1985 requires that a company's accounts, or the notes attached to them, should provide the following information:

- the aggregate of the emoluments, including expenses allowances, benefits in kind and pension contributions, paid to, or receivable by, the Directors during the relevant year;

- details of the Chairman's and, if he or she is not the Chairman, the highest paid Director's emoluments, excluding pension contributions;

- the emoluments of the Directors analysed by £5,000 bands, again excluding pension contributions;

- the aggregate of present and past Directors' pensions, excluding those paid or receivable from funded schemes but including the cash value of non-cash benefits and the nature of these benefits; and

- the aggregate amount of compensation for loss of office paid to, or receivable by, Directors or former Directors.

The Act also requires disclosure in the accounts, but not specifically under the heading of Directors' emoluments, of pension commitments included under any provision shown in the company's balance sheet and any such commitments for which no such provision has been made. Separate particulars must also be given of pension commitments to past Directors.

Companies quoted on the London Stock Exchange have, in addition, to give details of any emoluments waived by a Director during the year in question together with any future emoluments the Director has agreed to waive.

The Report of the Committee on the Financial Aspects of Corporate Governance recommended that disclosure of the Chairman's and/or highest paid Director's emoluments should show salary and performance-related elements separately and should include as a separate item details of the pension contributions paid in respect of them.

APPENDIX II

ILLUSTRATIVE DISCLOSURE FORMATS

The two accompanying tables give possible formats for disclosure of (a) remuneration and (b) share options and other forms of long-term incentive schemes. The formats are illustrative and not mandatory.

Summary remuneration table

This table is intended to bring together, in one place, the value of all of the various elements of remuneration received by each director during the year.

	Salary & fees	Benefits	Annual bonus	Other	Total	Prior year total	Long-term incentives Current year	Long-term incentives Prior year	Pensions Current year	Pensions Prior year
	(Note 1) £000	(Note 2) £000	(Note 3) £000	(Note 4) £000	£000	£000	(Note 5) £000	£000	(Note 6) £000	£000
Executive										
A										
B										
C										
D										
E										
Non-Executive										
F										
G										
H										
	___	___	___	___	___	___	___	___	___	___
	___	___	___	___	___	___	___	___	___	___

Note 1 A separate analysis of fees for non-executives, separating Board and committee fees, may be given.

Note 2 The value of benefits in kind received during the year should be given, with a summary of the main benefits and separate analysis where material.

Note 3 An explanation of how the annual bonus is related to performance should be given, together with a statement of any portion of the bonus awarded in shares.

Note 4 Other elements of remuneration, including compensation for loss of office, should be shown.

Note 5 Gains made on share options exercised during the year or the value of shares or cash payments received under other long-term incentives should be shown. Performance criteria, and the extent to which met, should be stated.

Note 6 The value of pension benefits received should be shown (when recommendations from the Faculty of Actuaries and Institute of Actuaries are finalised).

Share options and other long-term incentive schemes

This table is intended to indicate the potential or actual longer term commitment of shareholders' funds, or prospective dilution of equity, arising from grants of share options or commitments under other forms of long-term incentive scheme.

	No. of options							
	At start of year	Granted during year	Exercised during year	At end of year	Exercise price	Market price on date of exercise	Date from which exercisable	Expiry date
A	X		(X)	—	xp	xp		
	X			X	xp		19XX	19XY
		X		X	xp		19XX	19XY
B								
C								
D								
E								

Note. The illustrative table is based on that shown in UITF 10. A similar format could be used to show conditional grants of shares under other forms of long-term incentive scheme.

APPENDIX III

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