



Bringing the Yin-Yang balance to boardrooms – the role and responsibilities of the Senior Independent Director

The City is very familiar with the roles of Board Chairman, Chief Executive Officer and Finance Director. However, often overshadowed by these prominent roles is another voice in the boardroom which has grown increasingly more important to investors. This voice has been fighting the corner for minority shareholders in boardroom battles and has gained little recognition for their efforts. This voice comes from the “Senior Independent Director”.

In July 2003, the Financial Reporting Council published the ‘Combined Code’ which laid out a number of underlying principles for good corporate governance practice in the UK. For implementation purposes, the Combined Code emphasised a two-sided process when enforcing its recommendations. Companies could either ‘comply’ with the Code’s provisions or alternatively ‘explain’ why they have deviated from the stated guidelines. This method was adopted in order to provide companies with the flexibility to depart from the provisions of the Code if they could not comply. Ultimately, the final decision rested on investors to accept the company’s position, seek further explanation or dismiss it entirely.

In its simplest form, a box ticking approach could be used in analysing corporate governance policies. However, judging whether a company’s explanation is acceptable for deviating from the Code’s provisions is an

essential way of meeting realistic expectations, despite being more contentious.

Following the Higgs Report, the role of the Senior Independent Director has made communication and application of the ‘explanation’ element of the Combined Code more effective. This edition of Fundamentals puts the spot light on the Senior Independent Director and how their presence in boardrooms is highly valued by LGIM.

Corporate Governance at LGIM

Corporate governance itself is concerned with the framework within which the board control and monitor the business of the company. It focuses on the responsibility of directors for setting strategic aims, establishing financial policies and overseeing their implementation as well as reporting to shareholders on the activities and progress of the company.

Inside:

Page 5

**Market Overview:
Recession or mid-cycle
slowdown?**

Page 7

**Snapshot:
US Housing Market
Uncertainty**

Page 8

**Forecasts:
Inflation expectations
picking up**

At LGIM, we consider good corporate governance and effective management as vital to the successful implementation of a company's corporate objectives. We embrace the full spirit of the Combined Code and believe that the two-sided 'comply' or 'explain' approach is practical in the enforcement of flexible corporate governance arrangements in UK companies.

The first point of contact to discuss any corporate governance issues should be the Board Chairman. As a major investor owning approximately 4% of the FTSE All Share Index, we strongly support this approach.

However, there are circumstances where our shareholding interests may potentially conflict with the Board Chairman's interests. Situations where this may occur include having a joint Chairman and Chief Executive Officer or the Board Chairman themselves is a controlling shareholder in the company.

In such circumstances, in order to avoid any conflict of interests, LGIM will move away from its usual practice of contacting the Board Chairman and arrange a meeting with the Senior Independent Director instead. These meetings should not be interpreted as a process to undermine the Board Chairman's position. In fact, these meetings improve the relationship between the board and investors by providing a complementary link in the communication chain.

Therefore, the role of the Senior Independent Director is to work alongside the Chairman and CEO and to act as a secondary supporting link between investors and the board.

So what are the main responsibilities of the Senior Independent Director and what is their main role?

The role of the Senior Independent Director

"The board should appoint one of the independent non-executive directors to become the Senior Independent

Director. The Senior Independent Director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve or for which such contact is inappropriate."

The Combined Code on Corporate Governance, July 2003, Section A.3.3

This statement in the Combined Code was first interpreted by some companies as being divisive and negative. Many believed that the Senior Independent Director would challenge the Board Chairman's role, risking miscommunication and wasting time. It was also believed that the role could be potentially harmful to an established board by dividing the loyalty of directors in the company.

Nevertheless, what experience has shown is far from this picture. The need for a strong independent figure head and alternative point of contact was actually welcomed by many investors.

The Senior Independent Director is seen to have restored balance in a boardroom where power and authority were unevenly concentrated in the hands of the few. Furthermore, the Senior Independent Director supported the role of the Non-Executive Chairman and, in some cases, will act as Deputy Chairman of the board.

At LGIM, we believe that the Senior Independent Director serves two main functions in companies.

Firstly, as highlighted previously, the Senior Independent Director should be acting as the main focal point for investors "if they have concerns through which normal channels of Board Chairman, Chief Executive Officer or Finance Director has failed to resolve or contact is inappropriate." This includes responding to requests for meetings and

being aware or developing issues between investors and the company.

Secondly, the Senior Independent Director should communicate well with the Chairman and CEO and monitor how the relationship is working but is important to avoid creating a "third front" where there is no need. This function becomes crucially important when seeking to ensure a smooth transitional process takes place behind controversial succession appointments. For example, the Combined Code warns against the Chief Executive Officer becoming the new Board Chairman. The risks associated with such succession processes are clearly visible to shareholders. There will be questions raised over whether the new Chairman will overshadow the role of the CEO in other management's eyes, and whether there will be sufficient independent judgement brought to the running of the board.

Sufficient safeguards need to be put in place in order to address any significant conflicts within the boardroom. LGIM would like to see this 'monitoring responsibility' being delegated to the Senior Independent Director of the company. The holding of regular separate meetings with the Chairman and the CEO should be used to reduce any apparent boardroom tension while the scheduled meetings will not be seen as a response to a crisis.

Other important duties

As corporate governance issues become increasingly important to shareholders, the Senior Independent Director's role and responsibilities has also developed into a more challenging and complicated position.

Besides the two main functions mentioned in the previous section, the Senior Independent Director is also responsible for chairing the nominations committee when considering

appointments for the Board Chairman’s position, conducting the performance evaluation on the Board Chairman and chairing board meetings if the Board Chairman is unable to attend.

These duties, in many ways, are similar to the tasks undertaken by a Deputy Chairman and LGIM supports the recognition of the role with this status.

The role is crucial for protecting all shareholders’ interests when a management buy-out or take-over is proposed. These transactions could have a direct financial and employment impact on individual directors while the board should aim for the best overall deal.

Are Senior Independent Directors undervalued?

In LGIM’s mind the answer to the above question is yes. We believe that Senior Independent Directors are not fully recognised for their important role in boardrooms.

The added commitment and dedication makes the Senior Independent role even more demanding than previously predicted. For example, in one company the Senior Independent Director was a catalyst in transforming an executive board with internal appointments to one where NEDs and an external CEO were recruited.

We will continue to support Senior Independent Directors and non-executive directors in order to increase shareholder value and mitigate any risks that may occur in the longer term. This includes adjusting the remuneration package of Senior Independent Directors in order to reward them for their added time and commitment to the role.

Senior Independent Directors pay

“Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-

NON-EXECUTIVE DIRECTORS
MEDIAN TOTAL FEE LEVELS (£) BY SIZE OF COMPANY

Market Capitalisation (£m)	Non-Executive Chairman	Non Executive Deputy Chairman	Senior Independent Director (SID)	Non-Executive Director (NED)	Difference between SID and NED
300 – 600	106,500	58,900	37,700	34,400	3,300
601 – 1,000	122,400	58,300	41,400	38,100	3,300
1,001 – 2,500	167,400	64,000	47,700	43,000	4,700
2,501 – 5,000	240,600	96,400	57,100	53,500	3,600
5,001 – 10,000	261,300	98,500	66,700	55,600	11,100
10,001 – 25,000	384,300	104,500	77,500	66,500	11,000
Over 25,000	537,400	181,400	95,400	74,500	20,900

Source: Deloitte

executive directors should not include share options. If, exceptionally, options are granted, shareholder approval should be sought in advance in any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director’s independence.”

The Combined Code on Corporate Governance, July 2003, Section B.1.3

Whilst we support the fact that non-executive director fees should not be too high to avoid comprising their independence, we believe that the Senior Independent Director should be provided extra remuneration for one-off services which demand more of their time and extends beyond their normal duties. This complies with the Code’s guidelines that “levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role”.

A majority of companies remunerate their Senior Independent Directors in the form of set basic fees which is similar to the payment for external services from a consultancy firm. Depending on the size and complexity of the business, the Senior Independent Director may receive on average an

additional £3,000 to £20,000 reflecting their service.

However, what if a particular Senior Independent Director task demands more of their time? For example, the search for a successor to the Board Chairman’s position may take a few months or over a year.

Will the Senior Independent Director receive any additional remuneration for spending extra time on this task? It depends on the company - and in some cases the standard directors’ fees are set with the expectation that it will cover all duties.

At LGIM, we would like to see Senior Independent Directors rewarded for the time they spend on a particular duty. This includes paying a supplementary fee for one-off services which may have required more time than previously expected. We would also like to see part of this additional fee paid in the form of shares, to be retained while a director, in order to align their interests with shareholders.

The Future...Recognition and Valued by Shareholders

The focus of shareholder contact must remain with the Chairman, the CEO and other management. But the Senior Independent Director’s presence in boardrooms has provided minority

shareholders with independent representation. The development of these relationships with investors is a clear strength of the UK governance model.

It has always been challenging for minority investors to scrutinise and influence management when there is a concentrated domineering force on the board. However, the existence of the Senior Independent Director balances this power and ensures that the minority shareholders' concerns and views are addressed.

LGIM would like to see the Senior Independent Director being properly recognised and acknowledged for what they do. We would like to see them valued amongst investors and the boards on which they sit. This can come from possibly a formal role as Deputy Chairman or through additional fees, partly invested in shares.

We believe that the evolving and developing role of the Senior Independent Director is a clear sign of the boardroom adapting to corporate

governance issues and taking into consideration shareholders concerns. The UK has developed a corporate governance model that supports business success along with protection for shareholders. The Senior Independent Director provides a crucial additional resource to guide the company to the best board structure and to maximise shareholder value.

Market Overview

Recession or mid-cycle slowdown?

Global equity markets recovered well from the sharp set back at the end of February. The FTSE world equity index increased by 1.5% through March, with the Emerging index up 3% and the Developed index up 1.1% (in local currency terms).

That said, there are some concerns among investors about the durability of the current recovery. A useful measure of equity market optimism is the ratio of analyst earnings upgrades to downgrades. The three-month moving average of this series for the World equity index has been below 50 for the past three months, implying downgrades are outnumbering upgrades. For the US market, the ratio has been at or below 50 for the past 8 months, and in the UK for the past six months. In stark contrast, upgrades have outnumbered downgrades in Europe for every month since early 2004.

The primary concern for analysts and investors over the coming year is the outlook for US corporate profits. Those concerns stem from slowing economic growth, rising interest expenses from higher rates and corporate re-leveraging,

higher unit labour costs arising from slowing labour productivity, and signs of deteriorating credit quality. All these factors point to slowing corporate profit growth through 2007, after nearly five years of double digit growth, and for many commentators are the early signs of recession.

Against that backdrop, it would seem wise for investors to be wary of the outlook for US equities. However, while economic and corporate profit growth slow prior to a recession, they also slow during a mid-cycle slowdown. The start of a recession is clearly not a time to be buying into equities, but a mid-cycle slowdown is very different and has the potential to lead to equity market re-rating as firms self-help through buybacks and M&A activity.

We believe the US is experiencing a mid-cycle slowdown, not a recession. While the above factors are clearly a concern, corporate balance sheets are very strong. Indeed, cash flow yields are running at 40-year highs, and this will continue to support M&A and provides easy access to finance for other investment opportunities. In addition,

we see the rising unit labour costs as positive for consumption. Indeed, overall labour compensation rose 5% through 2006 which will support top line growth and hence equity earnings. So while corporate profits may not grow at the same rapid pace as the last four years, the likelihood of a recession in corporate profits seems unconvincing to us.

London

Rising interest rate expectations

UK economic activity remained very strong through to the end of the first quarter. Labour market data were healthy, with a further fall in unemployment and stable wage growth. This supported a rebound in retail sales, which was boosted by clothing and household goods sales. Housing market data were somewhat mixed, with a slight fall in the RICS survey of prices. But with house prices still increasing at a double

digit pace, the MPC remain wary of the upside risks to broader inflation, which surprised on the upside in February. A further 0.25% rate hike is therefore expected to come in the second quarter, with the money markets currently pricing in around an 80% possibility of a further hike to 5.75% by the end of the year.

The UK equity market recovered its poise in March after the turbulence of the previous month to post a return of 3.3%. The strength of M&A activity continues to be the overriding driver of markets. March saw a bid approach for Alliance Boots from members of its management team back by venture capitalists. Cadbury Schweppes announced plans to demerge its beverages business to focus on confectionery whilst Whitbread signalled it had received a number of approaches for David Lloyd tennis clubs division. Mega cap stocks and sectors such as Pharmaceuticals, Telecomms and Banks had another disappointing month which held back the relative performance of the FTSE 100 index. We believe the fundamentals for the UK stockmarket remain sound, valuations continue to appeal and further corporate activity is in prospect.

Wall Street

Sub-prime concerns still dominating sentiment

US economic data remained somewhat weaker over the month as retail sales, durable goods orders and some manufacturing surveys disappointed market expectations. There were some positive data surprises however, from industrial production and existing home sales. The Federal Reserve will have been watching the inflation data, which surprised on the upside for February. They left policy rates unchanged in March, but in his comments, Fed Chairman Bernanke stated that inflation remained the predominant concern, and that growth was expected to continue at a moderate pace. Despite this, money markets are still pricing in at least one rate cut by the end of the year.

The S&P 500 was up 1% over March, buffeted by ongoing sub-prime mortgage delinquency trends and the softer economic backdrop. By sector, Financials were the biggest laggards over the month, being influenced by concerns in the sub-prime mortgage market. Private equity continues to play its part in supporting public market multiples. Affiliated Computer Services (IT services) and Dollar General (retail) were both taken private this month. Analysts expect S&P 500 earnings growth of 4% year on year over the first quarter, and 6% growth for 2007 – the slowest pace in four years. Going forward, equity market performance will depend largely on the Fed's response to economic data.

Europe

Stronger activity across the region

Economic activity continues to strengthen across the continent of Europe. Germany in particular is seeing an improvement in business and consumer confidence which is being reflected in corporate performance and bodes well for the balance of 2007. Unemployment continues to decline in the major economies, most notably in France and Germany and for the time being at least, inflationary pressures appear to be under control. Nonetheless, the ECB has deemed it prudent to raise interest rates to a level not seen since late 2001 and it seems likely that the year will see further rate rises as strong economic growth sees inflationary pressures build.

Of the major global equity markets, Europe continues to see the strongest performance, supported by strong growth reflected in good corporate earnings reports. In addition, there is the perception that stocks in Europe are undervalued, both compared to their global peers and in light of the improved economic environment. With corporate margins expected to remain high and cash flow generation very strong we can expect to see further merger and acquisition activity, as companies seek to exploit their under-leveraged balance sheets. We have already seen numerous high-profile transactions, Porsche's bid for control of Volkswagen, the bid for Endesa in Spain, Barclays' interest in ABN, to name but three and the coming weeks and months are likely to see further deals announced. This provides a firm support to markets already bolstered by strong corporate performance: with the ECB now managing expectations for further rate rises very well, European equities can be expected to remain buoyant.

MAJOR EQUITY MARKETS – TOTAL RETURNS £ 2006/2007

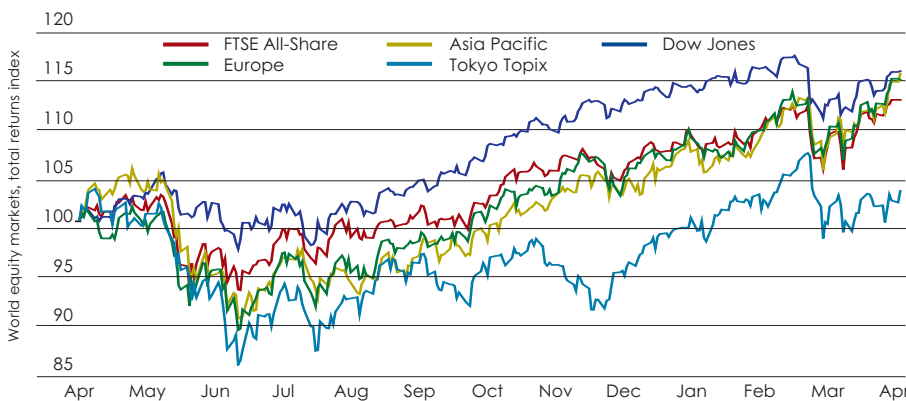


Figure 1

Source: Datastream

Japan

Land prices rise for the first time in 16 years

The Japanese stock market steadily recovered from the sharp sell-off in global markets seen at the end of February. Fears of a large correction in the carry-trade which would result in a stronger Yen have failed to materialise. Inflation in Japan has moved back into negative territory, suggesting that monetary policy will remain loose and interest rates low throughout 2007. In addition, the closely watched Tankan Survey marginally disappointed market expectations.

In recent weeks the equity market has started to factor in the potential for weaker demand from the US for Japanese exports, particularly autos, due to a potential negative spill-over from the weak property market to consumption. Real estate and asset plays continue to outperform the market with official land prices in Japan showing the first rise in 16 years. The Japanese stock market moving ex-dividend prompted profit taking in some of the higher yielding sectors such as utilities where valuations recently reached stretched levels on strong demand from domestic investors searching for higher returns, with interest rates remaining so low in Japan.

MAJOR WORLD BOND MARKETS – TOTAL RETURNS £ 2006/2007

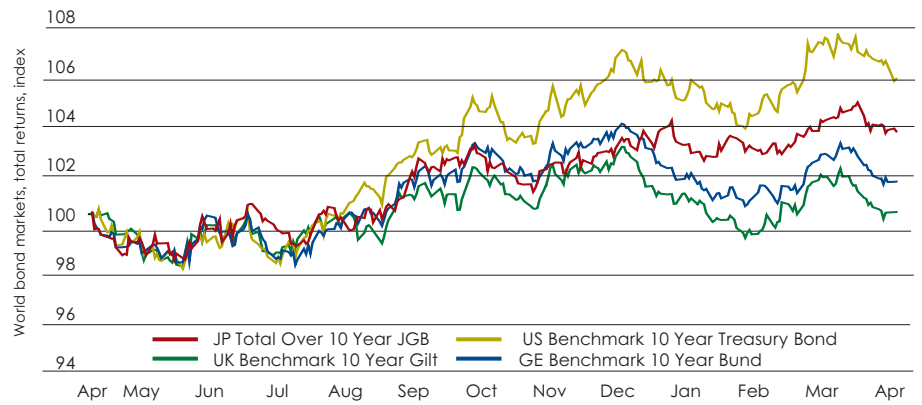


Figure 2

Source: Datastream

Pacific Basin

Investors facing conflicting signals

In March the FTSE AW Asia Pacific ended the month up 2.8% in sterling terms.

Investors have been faced with the conflicting signals of weaker US economic growth, tightening monetary policies in China and India on one side and with the continuing strength of Chinese economic data, firm commodity prices, rising shipping rates on the other. The region moved in a range from 286-305 (FTSE AW Asia ex Japan index sterling), closing at its high for the month.

Interest rates are expected to be cut by 0.5% in Thailand this month in an effort to revive a sagging economy. By contrast it is expected that rates will rise by 0.25% in Australia to temper the inflation outlook and if credit growth and the outlook for inflation in China and India fail to dampen, further bouts of monetary tightening can be expected.

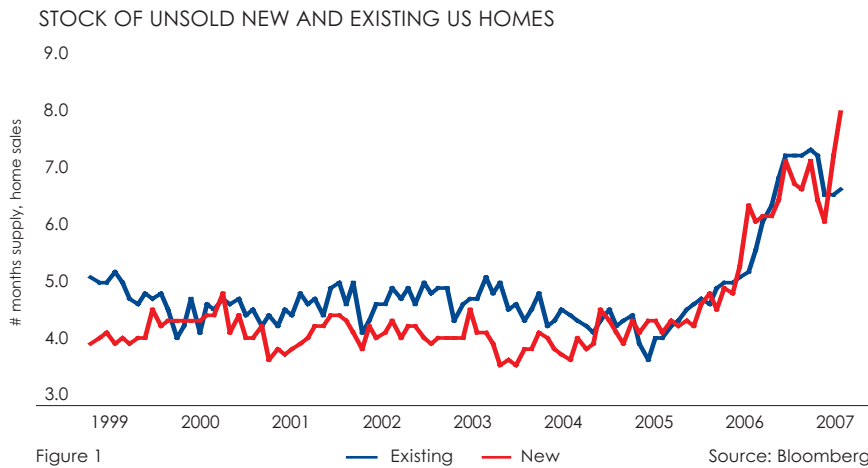
At 14x this year's earnings, which are expected to grow by between 11-14%, the valuation for the region as a whole can be described as reasonable. This indicates that stock selection will be a critical factor in driving future performance.

Snapshot

US Housing Market Uncertainty

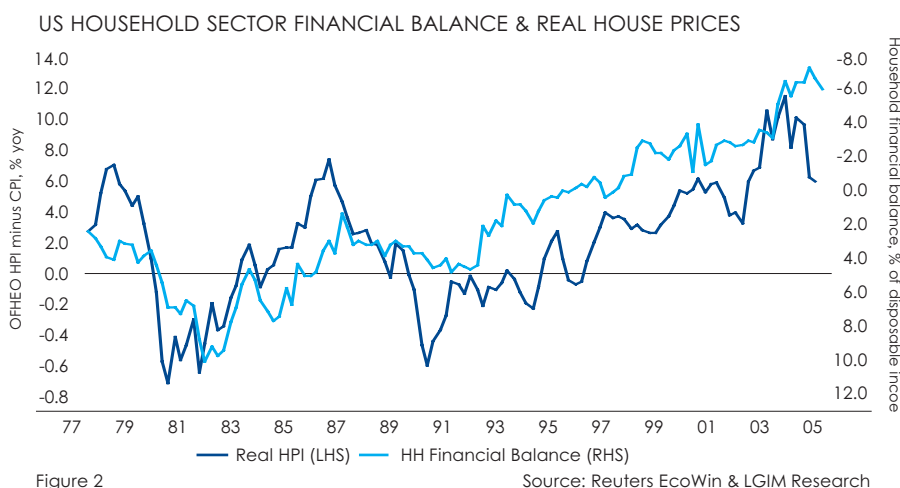
There has been considerable coverage of the state of the US housing market over the past 18 months, as the steady decline in home prices continued to threaten US consumer spending. It is little surprise then that the turnaround in the data in the latter part of 2006 led to hopeful speculation that the worst was over for the market. In particular, sales of existing homes have risen 7% from their lows, approvals for new mortgages are up 8% and consumer sentiment about housing affordability improved.

But care needs to be taken when assessing the impact of some US housing market data. The pick up in the construction of new homes at the end of 2006 and again in February, added weight to the argument that conditions were improving. However, not all increases in home starts are good news. Of all new homes built, around 30% are constructed on an owners land and of the remaining 70% some will have been pre-sold, but the remainder will have been built on a speculative basis, with the homebuilders hoping to find a buyer at a later date. With buyers of new homes still easing off, down nearly 20% year on year, it is unsurprising that the stock of unsold new homes spiked higher in February, illustrated by the red line in Figure 1.



The stock of unsold homes is particularly important for consumers, as this is an important driver of prices, which in turn will affect households' perception of wealth. The rise in US owner occupation rates and significant price appreciation since the mid-1990s contributed to the sharp increase in the household sector financial deficit, reaching over 7% of disposable income last summer, shown in the light blue line in Figure 2. This poses a significant downside risk to US consumption going forward, should the household sector begin to address this balance and rebuild their savings, as has happened to a small degree in the last two quarters.

Whist being cognisant of this risk, we are optimistic on the outlook for consumption on the basis that the labour market remains robust and nominal wage growth is the highest since 2000. For the housing market itself, we expect the data to remain volatile in the next few months as weather effects distort the data, but beyond the volatility, conditions are likely to show some signs of stabilisation.



Views Commentary

Inflation expectations picking up

	Price Inflation (RPIX)		GDP (Growth)		Earnings (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro		FTSE 100
	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007	End 2008	End 2007	End 2008	End 2007
ABN Amro	2.80	2.80	2.80	2.60	6.50	7.00	5.10	-	5.75	6.00	2.05	2.04	0.66	0.68	7000
Citigroup Smith Barney	-	-	3.10	2.80	5.60	6.70	4.90	5.00	5.40	5.75	1.94	1.93	0.66	0.64	6800
CSFB	1.80	2.30	2.70	2.80	6.20	6.60	4.70	-	5.50	5.50	1.89	-	0.68	-	6500
Deutsche Bank	4.20	2.60	2.70	2.10	6.50	7.00	4.90	-	5.50	-	1.85	-	0.73	-	6700
Goldman Sachs	2.40	2.80	2.60	2.60	7.90	8.90	4.80	5.00	-	-	1.95	1.95	0.69	0.69	-
HSBC Securities	2.10	2.20	2.20	2.20	5.00	5.00	4.30	4.60	5.25	4.75	1.93	1.83	0.72	0.74	6850
JPMorgan	2.30	2.60	2.90	2.80	-	-	-	-	5.50	-	-	-	-	-	-
L&G Investment Management	2.00	2.30	2.90	2.60	8.00	8.00	4.85	4.85	5.50	5.50	1.90	1.85	0.69	0.69	6450-6550*
Merrill Lynch	2.70	2.50	2.80	2.30	6.00	6.00	4.55	-	5.50	5.00	1.87	1.73	0.71	0.74	6450
Morgan Stanley	2.60	2.50	2.30	2.30	6.00	6.00	5.30	5.30	5.25	5.25	1.91	1.79	0.67	0.67	6550
UBS	2.70	2.90	2.80	2.70	5.30	9.40	5.00	5.15	5.25	5.25	1.91	1.90	0.70	0.71	6550
Median (ex L&G Inv Mgt)	2.60	2.60	2.75	2.60	6.00	6.70	4.90	5.00	5.50	5.25	1.91	1.90	0.69	0.69	6625
Last Month	2.30	2.50	2.75	2.75	6.00	6.60	4.80	5.00	5.45	5.25	1.91	1.90	0.69	0.70	6625
Actual end :															
2006		3.80		3.00		12.20		4.74		5.00		1.96		0.67	6220
2005		2.00		2.00		22.70		4.10		4.25		1.72		0.69	5618
2004		2.50		2.60		6.71		4.53		4.75		1.92		0.71	4814

KEY Median figures indicate change over previous month 0.00 increase 0.00 decrease 0.00 no change

*This is our estimate of fair value at end 2007, not a point forecast.

Respondents to our survey this month became a touch more pessimistic on the outlook for the UK economy. GDP growth expectations for this year were unchanged at 2.75%, but 2008 forecasts were revised down slightly with growth now expected to slow slightly to 2.6%. Inflation expectations meanwhile have been revised higher. RPI(X) inflation is expected to be at 2.6% both this year and next. Despite these revisions, the outlook for interest rates remains unchanged from last month. Rates are expected to rise to 5.5% this year, falling back to 5.25% next year.

Financial market expectations are largely unchanged from last month's survey. 10-year gilt yields are expected to fall back slightly from current levels to around 4.9% this year, rising to 5% next year. The FTSE 100 is still expected to be at 6625 at the end of the year, with the Bull-Bear gap unchanged at 550 index points. In the currency markets, respondents to our survey continue to look for sterling to weaken slightly against both the dollar and the euro.

For further comment on Fundamentals, or for additional copies, please contact Harriet Moore at harriet.moore@lgin.co.uk
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