

**THE ROLE AND EFFECTIVENESS
OF NON-EXECUTIVE DIRECTORS**

Marks & Spencer's response to the Derek Higgs' Review

16 September 2002

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THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS

The Board of Marks and Spencer Group p.l.c. welcomes the current review of Non-Executive Directors ("NEDs") and is happy to make its contribution to establish a clearer picture of the way boards operate today and to identify tangible measures to promote more effective boards.

This response is structured in the same format of the Consultation Paper issued by Derek Higgs on 7 June 2002.

EXECUTIVE SUMMARY

KEY ISSUES FOR MARKS & SPENCER

- The quality, **INDEPENDENCE** and contribution of NEDs is key to board effectiveness.
- We endorse the UK model of a **UNITARY BOARD** comprised of at least one-third independent directors.
- **DIVERSITY** among NEDs is to be welcomed to promote and encourage enterprise in corporate UK whilst safeguarding shareholder and wider stakeholder interests.

- **NO ONE SIZE FITS ALL.**

KEY ISSUES cont.

Section A : Role

- 1 A strong and independent body of NEDs is a necessary ingredient of boards, in particular to ensure the quality and effectiveness of executive leadership and that senior management succession planning is in place, and to carry out the necessary corporate governance functions
- 2 The Senior Independent Director acts as a key communication focal point and in special circumstances can galvanise action, eg relating to board succession or poor company performance.
- 3 There is no distinction in law between the duties of executive and non-executive directors. All directors are responsible for the stewardship of the company's assets and have a monitoring role to ensure that the necessary controls are in place. However, the draft statement of statutory duties does recognise that there are different levels of knowledge, skill and experience between directors.
- 4 Independence is not the preserve of NEDs. All directors should be encouraged to make their individual views known to the board. The external and internal auditors, the finance director and the company secretary also play important roles, with responsibility for maintaining their independence and objectivity when considering executive strategy and actions.
- 5 Independent NEDs should comprise at least one-third of the board. A higher percentage of NEDs may be appropriate in certain circumstances including non-independent NEDs.
- 6 Time commitment is unlikely to be less than 12 days per year and is more likely to increase, say to 15-20 days per year. Pay should recognise this whilst not creating reliance nor jeopardising independence.
- 7 The number of directorships that an individual is able to fulfil depends on the performance of the individual and the nature of the companies of which they are a director. Each company should determine its own requirements and be very clear to candidates on the time commitment expected from a NED in their company.

KEY ISSUES cont.

Section B : Attracting and Appointing NEDs

- 8 NEDs need to be adaptable and resilient and need to exercise complete confidentiality. They need to give the maximum output within minimum time. Three minutes with a NED should be time really usefully spent.
- 9 All the skills, experience and attributes of NEDs, together with a passion for the company's products and customers, are a powerful combination to bring to the board.
- 10 Diversity on the board should be encouraged to capture a wider representation of views, eg people with different nationalities, genders, business and other backgrounds. If a person does not have a business background there should be a significant compensating factor which enables them to add real value to the board, eg excellent customer or people focus.

Section C : Structures and Accountability

- 11 It would be helpful to have further commentary on independence taking the NAPF and Hermes models as examples and being mindful of current US proposals. Ultimately it is for the board to decide and disclose NED independence to shareholders.
- 12 The current Combined Code requirements are tried and tested - fundamental changes would not be welcomed. More important is the regular review of whether the board and principal committees are indeed working. This is the task of the appropriate chairman and secretary.

KEY ISSUES cont.

Section D : Relationships with shareholders and others

- 13 The principal focus for company communication should be the chairman and the chief executive who play key roles externally and internally. External consultation with NEDs should be limited to governance matters at the AGM and by exception to institutional shareholders.

Section E : Support

- 14 To make the best use of NED time and talent, board and committee meetings need to be properly scheduled, structured and working effectively. Together, the chairman and company secretary make sure the corporate process is in good working order, and that NEDs are sufficiently informed.

Section F : Smaller Listed Companies

- 15 No comment

Section G : International Context

- 16 The UK's governance model works and should be sufficiently robust to withstand any legislative or regulatory pressures currently being experienced in the US and Europe. Regular review of best practice underpinned by the experiences of successful UK companies should ensure continued effectiveness.

DETAILED RESPONSE

SECTION A : WHAT ROLE SHOULD NEDs PERFORM AND HOW DOES THIS COMPARE TO THE PRESENT POSITION?

A1 Role of the Board

The primary task of the **board** is to collectively promote the success of the company for the benefit of the shareholders as a whole (whilst recognising relevant stakeholder interests) by setting the strategic direction, monitoring performance of the group and its management, and ensuring the necessary controls are in place.

The **chairman** has prime responsibility for the working of the board, for the balance of its membership subject to board and shareholder approval, and for ensuring that all directors, executive and non-executive alike, play their full part in its activities by creating the climate of collegiate responsibility.

The **chief executive** is responsible for all aspects of the management of the company and its business, subject to such constraints and requirements to consult with, and seek approval from, the board as are laid down by the board from time to time.

The roles of the chairman and chief executive are distinct. In exceptional circumstances it may be in the best interests of the company to combine these roles for a period of time, for example, when strong leadership is required to turn a company's performance around. In these cases it is even more important to have a strong and independent body of NEDs in place.

NEDs bring an independent and external dimension to the board's discussion and decision-making and protect shareholders' interests by challenging the performance of executive management and through their roles on the key committees: Audit, Remuneration and Nomination.

<p>A strong and independent body of NEDs is a necessary ingredient of boards, in particular to ensure the quality and effectiveness of executive leadership and that senior management succession planning is in place, and to carry out the necessary corporate governance functions.</p>
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The **Senior Independent Director** ("SID") ensures that the views of each NED are given due consideration and provides a communication channel between the chairman and the NEDs and, when required, between NEDs and principal shareholders including representative bodies, eg NAPF and ABI.

The Senior Independent Director acts as a key communication focal point and in special circumstances can galvanise action, eg relating to board succession or poor company performance.

A2 Directors' Duties

General rules about directors' propriety of conduct and standards of skill and care are well rehearsed in the UK where successive case law has developed. It will be helpful to make this more accessible and we support the Company Law Review's to codify directors' duties.

We support generally the draft legislation that:

- these duties should apply to all directors;
- directors owe their primary responsibilities to shareholders;
- directors should also consider other factors that are material to the company's success, including relationships with other key stakeholders, impact on the community and the environment, and the need to maintain high standards of business conduct.

We also agree that there are differences in knowledge, skill and experience between executive and non-executive directors as recognised in the draft statement of statutory duties which currently states that "A director of a company must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both:

- the knowledge, skill and experience which may reasonably be expected of a director in his position; and
- any additional knowledge, skill and experience which he has."

No one should join a board without recognising their responsibilities and liabilities and companies need to examine the extent, terms and conditions of their Directors' and Officers' Liability insurance.

There is no distinction in law between executive and non-executive directors. All directors are responsible for the stewardship of the company's assets and have a monitoring role to ensure that the necessary controls are in place. However, the draft statement of statutory duties does recognise that there are different levels of knowledge, skill and experience between directors.

A3 Independence

All directors should be encouraged to make their individual views known to the board which should put in place the necessary controls to further safeguard the interests of shareholders and other stakeholders, eg its corporate governance committees. The board should expect to be challenged not only by strong and independent NEDs but also by others.

NEDs have a particular role to play in ensuring that the executive directors are acting in the best interest of the company without conflicting interests, eg not pursuing strategy to satisfy personal ambition.

Independence is not the preserve of NEDs. All directors should be encouraged to make their individual views known to the board. The external and internal auditors, the finance director and the company secretary also play important roles, with responsibility for maintaining their independence and objectivity when considering executive strategy and actions.

A4 Board Balance

A strong and independent body of NEDs does provide a balance on the Board so that no one individual or group of individuals can dominate the board's decision taking. A minimum of at least one-third NEDs on the board should be maintained and their contribution strengthened by requiring that all of that one-third be independent.

Individual boards should determine whether to increase that percentage of NEDs depending on the availability of suitable candidates and the company's circumstances. In our own case it has been helpful to have a larger percentage of NEDs - 50% - whilst the roles of chairman and chief executive were combined.

However, requiring a majority of the board to be independent as proposed currently in the US is not appropriate in all circumstances and could dilute the contribution of NEDs if there were insufficient supply of suitable candidates (albeit in the US they are proposing a 24 month delay in enforcing this rule).

Non-independent NEDs can also play a part. Although we do not generally endorse the retention of executive directors in a non-executive capacity as they cannot be considered independent, there may be exceptions.

Independent NEDs should comprise at least one-third of the board. A higher percentage of NEDs may be appropriate in certain circumstances including non-independent NEDs.

A5 Time Commitment and Pay

Any person in the role of NED should ensure he or she has sufficient time to fulfil the responsibilities of that role. This will include not only attendance at board and committee meetings and AGMs but also sufficient time to prepare for the decisions to be taken at those meetings, seeking additional information if required. Committee chairmen will similarly be responsible for the workings of their committee, spending sufficient time with the committee secretary and other members.

Time commitment will depend on the individual responsibilities. Our recent experience has been that although we have reduced the number of board meetings to 8 per year, the number of Committee meetings is increasing.

The pay levels should strike the right balance between recognising contribution and time spent, whilst not paying so much as to create reliance on that income nor jeopardise independence.

Time commitment is unlikely to be less than 12 days per year and is more likely to increase, say to 15-20 days per year. Pay should recognise this whilst not creating reliance nor jeopardising independence.

A6 Number of Directorships

The number of directorships that an individual is able to fulfil depends on the performance of the individual and the nature of the companies of which they are a director. Each company should determine its own requirements. The board should have a formal process to approve external directorships, which is unlikely to be more than one other significant plc appointment for executive directors nor 3 other significant appointments for NEDs, from which they retain any remuneration.

The number of directorships that an individual is able to fulfil depends on the performance of the individual and the nature of the companies of which they are a director. Each company should determine its own requirements and be very clear to candidates on the time commitment expected from a NED in their company.

SECTION B ATTRACTING AND APPOINTING NEDs

B1 Skills and Attributes

NEDs need to be adaptable and resilient and need to exercise complete confidentiality. They need to give the maximum output within minimum time. Three minutes spent with a NED should be time really usefully spent.

NEDs add value to the board by offering independent advice to the chairman and executive directors. They need to understand the business whilst sharing ownership of the company's strategy without compromising their independence. They have to operate at the strategic level, being able to understand the principal elements, eg people, markets, product development and competition. NEDs may also bring valuable expertise to complement the skills mix generally on the board and to enhance the role of the committees. Being a good communicator with good interpersonal skills is key. They need to be able to express their opinions and listen to those of their executive and non-executive colleagues. Mutual trust and respect in the board room will engender healthy debate where independent views are encouraged.

Experience of change and crisis management is helpful and increasingly an awareness of social, environmental and ethical issues including:

- ability to recognise emerging values and reconcile conflicting interests;
- getting the best out of people to pursue corporate strategy;
- being sensitive to the company's impact on society.

At Marks & Spencer, having a passion for our product and thinking customer in all that we do is essential.

These skills and attributes, of course, are also valuable in our executive directors, whose exposure to more experienced NEDs will help broaden their outlook and capabilities.

All the skills, experience and attributes of NEDs, together with a passion for the company's products and customers, are a powerful combination to bring to the board.

B2 Talent Pool

The role of NEDs has been raised progressively since the Cadbury Code in 1992. However, more could be done to promote the positive contribution they make, eg to the development of a company's strategy and its success, in addition to their monitoring function.

There have been many organisations who have helped to promote the role, eg ProNED, the IoD and 3i. Companies look to search/recruitment agencies to provide candidates. These can play an active role in securing individuals from a wider source, both at home and from abroad. Capable and intelligent people are not restricted to a particular sector of society.

The NED role should be promoted as a valuable means for successful people to broaden their experience. At Marks & Spencer we encourage our own employees to take on NED and other governance roles, which could be in other businesses or in not-for-profit organisations, maybe in health, education, community or the arts.

People joining a board should be given sufficient training on the role of the board and their function within it, together with an induction into the business operations and its people.

Diversity on the board should be encouraged to capture a wider representation of views, eg people with different nationalities, genders, business and other backgrounds. If a person does not have a business background there should be a significant compensating factor which enables them to add real value to the board, eg excellent customer or people focus.
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SECTION C : STRUCTURES AND ACCOUNTABILITY

C1 Assessment of Independence

It would be helpful to have further commentary on independence in the latest review of NEDs. The guidelines from NAPF, devised in conjunction with other City institutions is a start:

"In assessing the independence of a NED the assumption is that the individual is independent unless, in relation to the company, the director :

- was formally an executive;
- is, or has been paid by the company in any capacity other than as a NED;
- represents a trading partner or is connected to a company or partnership (or was prior to retirement) which does business with the company;
- has been a NED for nine years - ie three 3-year terms;
- is closely related to an executive director;
- has been awarded share options, performance-related pay or is a member of the company's pension fund;
- represents a controlling or significant shareholder;
- is a new appointee selected other than by a formal process;
- has cross-directorships with any ED;
- for whatever reasons, is said by the company not to be independent.

There may be other circumstances which could cast doubt on the independence of a NED."

Hermes' remarks are also helpful : "The board should have a core of at least three vigorously independent directors on whom shareholders can rely for the independence of their judgement and who can act as agents for change should the need arise." Current US proposals state that an independent director should have no material relationship with the company and provides commentary.

<p>It would be helpful to have further commentary on independence taking the NAPF and Hermes models as examples and being mindful of current US proposals. Ultimately it is for the board to decide and disclose NED independence to shareholders.</p>
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C2 Governance Structures

The Combined Code strikes the right balance on corporate governance providing an overall framework whilst not being overly prescriptive. Shareholders should be assured that board and committee performance is regularly reviewed. However, these assessments should be kept private. Public disclosure of individual and team performance is not appropriate as this would prevent honest appraisal and assessments could be taken out of context.

At Marks & Spencer we have recently introduced performance management and coaching throughout the company. Each individual is now assessed against objectives agreed with their line manager. The objectives of the executive directors are agreed with the Chief Executive and these are all presented to the Remuneration Committee for approval.

<p>The current Combined Code requirements are tried and tested - fundamental changes would not be welcomed. More important is the regular review of whether the board and principal committees are indeed working. This is the task of the appropriate chairman and secretary.</p>
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C3 Separate Meetings of NEDs

It is helpful for NEDs to meet separately from the executive directors. Where possible, to make the best use of their time these meetings should coincide with scheduled meetings, eg private discussions as required before or after committee meetings.

At Marks & Spencer the Chairman meets regularly with the NEDs and the SID is empowered to call a special meeting of the NEDs as required.

C4 Disclosure

Shareholders should be regularly informed on a company's performance through annual reports, the AGM and increasingly use of the website for more regular communication.

At Marks & Spencer we are currently investigating what additional information should be available on the company's intranet and internet, eg committee terms of reference and policies.

SECTION D : RELATIONSHIPS WITH SHAREHOLDERS AND OTHERS

D1 Communication

Consultation with NEDS should be limited to their governance duties, eg

- AGM resolutions, eg Audit and Remuneration Committee chairmen;
- succession - Nomination Committee chairman;
- leadership or other business-related issues - Senior Independent Director.

They may well have their own external communication network to pursue more general interests. This should not be confused with their relationship with the company.

Their relationship within the company can often be overlooked. They can provide a sounding board for members of the executive team and a development role for more junior people.

The principal focus for company communication should be the chairman and the chief executive who play key roles externally and internally. External consultation with NEDs should be limited to governance matters at the AGM and by exception to institutional shareholders.

SECTION E : SUPPORT

E1 Maximising NED Contribution

The chairman plays a key role in enabling the NEDs to play their full part as a member of the board and in so doing maximises the contribution from the NEDs. He is assisted by the company secretary who is the first point of contact for all governance matters.

The company secretary's role includes:

- giving support and advice to all directors on the performance of their duties;
- assisting with the induction and departure of directors;
- arranging training, either in the operation of the company or on governance matters;
- being a conduit for communication with shareholders generally;
- being the corporate conscience, alerting directors to matters of integrity and ethics;
- through tact and diplomacy ensuring directors work together and goals are achieved;
- supporting the chairman in continually improving board and committee effectiveness.

It is also helpful to provide NEDs with sufficient office support, eg meeting room, secretarial assistance for business related to the company, whilst not creating a

dependence on these facilities.

To make the best use of NED time and talent, board and committee meetings need to be properly scheduled, structured and working effectively. Together, the chairman and company secretary make sure the corporate process is in good working order, and that NEDs are sufficiently informed.

SECTION F : SMALLER LISTED COMPANIES

No comment

SECTION G : INTERNATIONAL CONTEXT

G1 Governance Models

The UK corporate governance model is working. The Codes of Practice have been well established since Cadbury with regular reviews through the Committees of Greenbury, Hampel and Turnbull and this latest review headed by Derek Higgs. The Company Law Review has been in process since 1998 and is now drawing to its conclusion.

The UK's governance model works and should be sufficiently robust to withstand any legislative or regulatory pressures currently being experienced in the US and Europe. Regular review of best practice underpinned by the experiences of successful UK companies should ensure continued effectiveness.

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