THE BEHAVIOURAL DRIVERS OF

BOARD EFFECTIVENESS:

A PRACTITIONERS' PERSPECTIVE

SUMMARY OF FINDINGS

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BACKGROUND TO THE RESEARCH AND SUMMARY CONCLUSIONS

The fundamental challenge: adhering to Corporate Governance codes is not enough

There have been many attempts to understand better the ambiguous and changing world of the Boardroom and to determine what makes an 'Effective' Board. One might imagine that it is relatively easy to identify businesses that have enhanced shareholder value and follow the trail straight back to the Boardroom to find the answers that we seek. Alas, this proves to be a false trail, for it turns out that there is no clear statistical link between following the corporate governance agenda and enhancing shareholder value. It is a self-evident truth that successful businesses operate under a broad range of boardroom structures – unitary and non-unitary; combining Chairman and CEO roles and splitting them; with independent directors and without them. In addition, many privately owned companies have significantly enhanced shareholder value with board structures that a publicly listed company, or corporate governance specialist, would barely recognise at all. Conversely, many companies that have ticks in all the right 'governance' boxes go on to perform disastrously.

Today, this whole dilemma is given an extra twist by the context in which Boards now operate. Over the last decade a 'seat on the Board' has gone from being a virtual guarantee of a painless and sustained passage into the hierarchy of the 'Great and the Good', to being a highly visible and pressured role, exposed to the commentary of anybody and everybody, together with the far more prevalent threat of litigation. Previously, the politics of the Boardroom were played out behind closed doors, with indiscretions, disappointed ambitions and the trail of blood and bones that tend to follow 'lean and hungry men' as they pursue the pinnacles of power, swept under the carpet. Now the activities in the Boardroom are part of the politics of the external world; a world which does not lend itself to measured reflection upon 'politically incorrect' conclusions.

Given this state of affairs, it is plain that following the various codes can help to provide safeguards for Boards and act as an insurance policy, perhaps even a perceived 'indemnity' against the actions of lawyers acting on behalf of disaffected shareholders – but is not on its own a recipe for delivering the shareholder value growth that is the ultimate mandate of the Board.

Identifying what really matters: our research approach and scope

So where should we seek answers to the question of what makes a successful Board? In our view the greatest determinant of a Board's success or failure is embedded in the collective and individual behaviour of its members. However, unwilling to accept our own view without testing it, we sought the views of seasoned Board members. To do this, we conducted research involving individual interviews with around 70 Board Directors. These individuals collectively brought nearly 1,000 years' experience of operating as Chairmen, Chief Executive Officers (CEOs), Non-Executive Directors and Executive Directors on over 125 public company Boards in the UK and circa 75 others internationally, covering over 20 different countries. (A selected list of some of the companies covered is provided in Appendix 1). Notably, 90% of those we approached to participate agreed to take part, an indication of the strength of feeling surrounding this issue. We further tested our emerging conclusions at a series of events with 45 experienced Board members, about a third of whom had not been involved in the earlier interviews.

In this research, we asked *"why?"* – why do people join Boards and how do their motivations to do so impact their behaviour? In particular, why do they place their reputation on the line and expose themselves to the intense scrutiny of a vocal lobby which is largely made up of people who have never actually run a business or engaged in any commercial entrepreneurial activity, and many of whose experience is limited to sectors notorious for their inefficiency and unaccountability? This question is especially relevant for the Non- Executive Director; they are there because they want to be there; not for them a requirement to feed the family and pay the rent.

We also asked *"what?"* – what are the drivers that then determine behaviour in the role, what are the behaviours that can raise the red flags and what should Boards do to deal with the consequences? As J G Ballard asks: "what are the 'reasons' and the 'nightmares'? The 'reasons' driving behaviour may be well intentioned; the 'nightmares' may be the consequences."

Finally we asked *"how?"* – how are the consequences of the best and the worst behaviours manifested and how are these managed to result in different degrees of Board effectiveness and associated success or failure?

Our findings (1): behaviour is of critical importance in Board effectiveness

During the discussions to seek to answer these questions, we found the importance of behaviour was endorsed and, even more valuably, there was a readiness to share hard learnt experience about how behaviour impacts effectiveness, as one participant put it, *"processes, information and governance mechanisms are important, but I passionately believe that behaviour is what really makes the difference between good and bad Boards"*; another said *"behavioural dynamics are key – processes, structures and procedures can only do so much"*. The research clearly reinforced the 'inconvenient truth' that a Board can have the clearest and the most robust processes and adherence to Governance principles, but if its members do not have the courage and judgement to call out and deal with the real issues facing the business in a timely and direct manner, the Board will fail to add value and may end up destroying it.

Our findings (2): seven actionable insights

We, along with the participants of this research, have witnessed at close hand the best and the worst of those boardroom behaviours, that have contributed in equal measure to outcomes of both success and failure, salvation and destruction. From these experiences, we have sought to shape our combined perspectives into actionable insights for practitioners, rather than academic observations, which we believe will be of value to Chairmen and other Board members, as they seek to create more effective Boards in pursuit of shareholder value in the challenging business climate of the post-crunch decade.

These insights into Board Effectiveness fall under seven broad headings. The chapters that follow outline each theme in more detail, but in summary our key conclusions are:

- *It starts and ends with the Chairman:* The single biggest determinant of a Board's effectiveness is its Chairman: he or she has the primary role for determining its focus, sets the tone for discussions and leads its composition. Being a Chairman is a demanding and difficult role that requires a set of skills different in many respects from those that underpin a successful executive career, in particular as CEO, notably in requiring high levels of emotional intelligence.

- *The CEO must engage constructively with the Board:* Alongside a skilled Chairman, it is critical that the business is led by a CEO who sees the Board as a valuable resource to be leveraged and who ensures effective engagement between the Non-Executive Directors and the Executive team. If the CEO's attitude is wrong, either it needs to be changed or the CEO does.

- *Balance on Boards is key:* The best Boards have good balance along three dimensions. The most important relationship that has to be balanced is that between the Chairman and CEO: this needs clarity of roles, mutual respect, complementary profiles, the right blend of support and challenge and frequent and open communication. In addition, it is also necessary to ensure a good balance between the CEO and his or her team, and also amongst the Non-Executives.

- *Being a great NED is as much about character as competence:* The most effective Directors have not only the experience and capabilities required by the particular Board, but just as importantly the right character. This involves five key elements ('the 5 Cs of character'): the right catalyst or motivations; commitment and engagement; a challenging and independent mindset; a collaborative and constructive style; and, above all, real courage to remain focused on what is right about the business and not to worry about personal reputation.

- *The Board needs to be designed and managed as a high-performing team:* Chairmen need consciously to create the conditions for a high performing team. This involves six key elements: building a common purpose; optimising Board size, typically between 8 and 12; ensuring mutual respect and commitment; engineering diversity – especially of thought patterns; investing in team building; and addressing weak links.

- *The best Boards make skilful use of three key safety valves:* Our research highlighted three key 'safety valves' that can be invaluable in surfacing and addressing key issues inhibiting Board effectiveness – but that equally can be at best window-dressing and at worst potentially dangerous if used poorly. These are the role of the Senior Independent Director; formal Board Effectiveness Reviews; and the support of the Company Secretary.

- *Identifying and managing 'red flag' issues is the acid test:* The best Chairmen and the best Directors are constantly alert to potential dangers that can derail even successful Boards: these include the potentially corrosive influence of power and success; self-congratulation and hubris; and above all the personal drama of succession events. They have the courage and skills to identify and intervene effectively in these issues before they become critical.

SEVEN ACTIONABLE INSIGHTS FOR PRACTITIONERS

1. It all starts and ends with the Chairman

The Chairman is the cornerstone of the Board and is expected to bring valuable credentials and a personal franchise, which has usually taken years to develop; he or she should have accumulated respect, trust, judgement and a following along the way. The Chairman is the single biggest determinant of a Board's effectiveness: he or she has the primary role in determining its focus, sets the tone for discussions and leads its composition. Our respondents were united in underscoring the Chairman's importance on the modern Board: as one put it, *"this is a critical job, not a position"*, whilst another stressed *"if you've got a good Chairman, everything else will follow"*.

Importantly, it is a demanding and difficult role that requires a set of skills that is different in many respects from those that underpin a successful executive career, in particular as CEO. Great CEOs don't necessarily make good Chairmen, and equally the best Chairmen may not have been CEOs themselves. Whilst sector experience can be valuable (in particular in technically complex areas, like financial services), it is ultimately a less important determinant of success in the role than having the right characteristics to be a great Chairman, providing that those are allied to a high degree of commercial intelligence. *"You need to understand the business, but not necessarily to come from the sector"*, said one Director; another said "*Chairman skills are much more important than deep industry expertise"*.

So what makes a great Chairman? Our research highlighted six key characteristics:

- *The right motivations:* Most fundamentally, it is vital that the Chairman is driven by the right motivations. Chairmen need to be clearly and unambiguously focused on promoting the success of the company and on looking after the interests of shareholders and other stakeholders – and not concerned about using the role as a platform from which to promote their own profile, network or concerns. "*The Chairman must have the integrity always to put 'company' before 'self'"*, one Director commented; another argued that *"the Chairman must be practically and emotionally committed to the business, not a self-promoter with their own ego to feed"*.

- *Commitment and engagement:* These are demanding roles and the Chairman needs to devote the necessary time and energy. Whilst the extent of the time required will vary with the scale of the business, for FTSE 50 companies two days per week is typically the minimum required. Successful Chairmen do much more than prepare for and run formal Board sessions: they maintain a regular dialogue with the CEO, they get out and about in the business and connect with a range of executives, they invest in keeping Non-Executive Directors abreast of developments, and they cultivate external relationships and networks that provide useful perspectives on and for the business. They need of course to avoid overstepping the boundaries of their role but they must be *"intelligently and meaningfully engaged in the business"* so that they have a good read on the issues faced and a sharp sense of the pulse of the organisation.

- *EQ as well as IQ:* Whilst there is no single optimal model of Chairmanship, effective Chairmen not only have the necessary business intelligence but also a high level of emotional intelligence. As one Director put it *"big, bruising CEO-style leadership is not right; you need emotional maturity in spades"*. It is a role that requires well-developed interpersonal skills – to build and motivate the Board, to forge an effective relationship with the CEO that is simultaneously collaborative and challenging and to adapt one's style to the needs of different situations. The Chairman needs to be a role model for respectful, collegiate and open interaction between Board members. *"It's about subtle leadership not dominance; it's not for alpha males"* concluded one respondent.

- *Optimising Board composition:* A key responsibility for the Chairman is to build the right Board and to manage Non-Executive succession in a thoughtful, proactive and measured way – *"a real skill"* in the view of one seasoned Director. This is an area where great improvements in professionalism have been made in the UK in recent years: the days when selection to Boards was based on patronage – and produced *"large numbers of decorative people who didn't role their sleeves up"* – are largely gone (although our respondents observed that old habits still endure in many other geographies). Now the best managed Boards follow a well-structured and rigorous process of identifying the collective capabilities required, agreeing key gaps and then searching for candidates with the skills and experience required.

- *The right agenda with the right rhythm:* The Chairman needs to ensure that the Board spends its time on the right issues. At a macro-level, this means that the right balance needs to be struck between governance and key strategic or performance issues. But more specifically, the Chairman – in consultation with the CEO – needs to identify and anticipate the key issues the business faces, ensure that the Board has the chance to explore these thoroughly well in advance of key decision points and provide the necessary information and context to ensure the Board is fully prepared.

- *Effective Board management:* Finally, the Chairman needs to be able to manage the Board meetings themselves to enable collaborative but robust discussions on these issues. Whilst there is no 'one size fits all' model here, a number of key lessons are clear:

    - Don't be a slave to the process: Whilst it is important to have clear agendas and to manage time well, good Chairmen do not put process ahead of substance and allow discussions to flow sensibly. *"You have to avoid the tyranny of the agenda and legitimise the second, third and fourth questions on topics"* said one Director. Another called for *"disciplined but not dogmatic management of the meetings, giving people the capacity to speak but not endless time to talk"*.
    - Encourage contributions from all: Chairmen should manage but not dominate the discussion. They should set the scene on each issue as appropriate to ensure clarity on the objective of the discussion, but then typically tend to talk last not first, instead drawing out thoughts and perspectives from different Board members. Chairmen need to be self-effacing, well-mannered and good-humoured to set the right tone of relaxed but purposeful debate.
    - Legitimise challenge: It is critical that the Chairman not only allows but actively encourages the expression of questions, concerns and contrary points

of view – not, in the words of one Director, *"regarding questions and interjections as a nuisance which interrupts the smooth flow of Board business"*. Indeed, the Chairman should ask the awkward question if no-one else does.

- Summarise and synthesise: The Chairman then needs to summarise the key strands of a discussion, to synthesise the consensus opinion of the Board and propose a conclusion or agreed set of actions. This requires active listening as well as crispness and clarity of thinking and communication – *"very hard to do on the hoof but incredibly important"*, one Director observed.

2. <u>The CEO must engage constructively with the Board</u>

Alongside a skilled Chairman, it is critical that the business is led by a CEO who sees the Board as a valuable resource to be leveraged and ensures effective engagement between the Non-Executive Directors and the Executive team. As one Chairman put it *"if you have an imperial or celebrity CEO, it's very hard to get around";* another observed *"it's very dangerous if the CEO does not work constructively and openly with the Board"*.

Ultimately the CEO needs to know that they hold their position at the will of the Board and the Board must be prepared to remove the CEO if all other options have failed. If the Board are not confident they are getting the full story about the business, they have no alternative – however strong the business performance appears to be – as they cannot be effective from a position of partial knowledge.

Our research highlighted four key lessons here:

- *<u>The CEO needs to embrace the Board:</u>* The CEO needs to view the Board as a source of experience and insight to be leveraged, not a nuisance to be managed. It is the Chairman's responsibility to ensure the Board is comprised of people with relevant skills and backgrounds, but the CEO needs to be *"genuinely interested in the Board's input, not seeking to dominate discussions or being passively aggressive"*, as one Director said. Too many CEOs are prone to attempting to stage manage discussions or reduce the Board to a rubber-stamping role, but *"it's not tenable to have anything that falls short of a constructive relationship"* as one Chairman argued. It is often helpful if the CEO sits on an external Board as a Non-Executive Director: this can provide important lessons in the value of constructive engagement and empathy and on what it takes to enable the Board to make a useful contribution.

- *<u>The CEO must role model open and constructive dialogue:</u>* The CEO needs to work with the Chairman to make sure the Board is properly prepared for discussions – through providing the right information and professional Board papers, as well as keeping them abreast of issues before they reach key decision point. Even more importantly though, the CEO must encourage and legitimise challenge, listening without defensiveness and welcoming input. *"The CEO needs to have the self-confidence not to be right and certain all the time…he must be willing to bring questions to explore, not answers to sign-off"*, one experienced Director observed. He or she needs to role model to Executive colleagues open support for the Non-Executive Directors and the contribution they can make – *"to accept that there are no dumb questions and to accept input as constructive challenge, not criticism"*.

- *The CEO must encourage engagement outside of meetings:* It is important that the CEO does not seek to minimise or control contact between the Non-Executives and senior managers outside of formal Board sessions. Such open and transparent informal interactions are critical in building up trust, forging relationships and giving the Non-Executives a richer and deeper feel for the business. The most confident CEOs allow *"unfettered access to information and to the business"*, said one Director; *"informal contact should be easy and unrehearsed"*, argued another.

- *If the CEO has the wrong attitude, it must be addressed by the Chairman:* However good the CEO is, the clear message from our research was that if he or she does not engage constructively with the Board, this cannot be allowed to go unchallenged – and indeed that the roots of a number of the most infamous business failures of recent years lies in the willingness of Boards to tolerate this. *"Ultimately behaviour beats strategy and it must be non-negotiable"*, said one Director. It is the responsibility of the Chairman not just to manage the Board but also to manage the CEO – *"being prepared to control the length of the leash and to flex it over time"* as one Chairman described it. This involves coaching the CEO on how best to engage with the Board, recognising any early signs of defensiveness or opacity and calling him or her to account, and ultimately being prepared to confront the behaviour, with the support of the Non-Executive Directors, removing the CEO if necessary.

3. Balance on Boards is key

Effective governance and the smooth operation of a Board require a sensible balance of power. As one Director mused, *"no one is perfect and, if they are, not for long"*. Indeed this notion of balance is central to the UK corporate governance regime, in particular the separation of power between the Chairman and CEO that is generally felt to be one of the pivotal elements of the Combined Code. The best Boards have good balance along three dimensions: between the Chairman and CEO; between the CEO and his or her team; and amongst the Non-Executives.

The critical relationship on the Board is between the Chairman and the CEO: indeed, if this is not working well, the chances of the Board functioning effectively are slim. The best relationships are characterised by five key features:

- *Clarity on roles:* There is no single right answer on the precise division of responsibilities between the CEO and Chairman, and hence the role of the Chairman. Although all would agree that the CEO is the key figure in driving the business – *"the CEO must be the first person you think of, when you think of the business"*, said one Director – the role of the Chairman will reflect in part the challenges the business faces, the relative experience and backgrounds of the CEO and Chairman, and their personal preferences on how they will spend their time. It is vitally important that each Chairman and CEO sit down and agree together, ideally in writing, both their respective roles and how they propose to work together; understanding and respecting each other's role is the bedrock of a good relationship.

- *Mutual respect:* The Chairman and CEO don't need to be friends; indeed, if the relationship is too close, there can be a danger of losing the challenge required.

Nevertheless, they need to have a high degree of mutual respect for each other's skills and value and good personal chemistry and empathy.

- <u>*Complementarity and balance:*</u> The Chairman and CEO represent a team and therefore they should ideally bring complementary skills, experiences and profiles; if they are too similar, then they may either overlap and clash or alternatively settle into a cosy and uncritical routine. At the same time, it is important that they balance each other well: *"the stronger the CEO, the stronger the Chairman needs to be"*, pointed out one Director.

- <u>*Support and challenge:*</u> The relationship needs to strike the right balance between support and challenge. Clearly, if there are major tensions or a lack of trust then it is difficult for the business to prosper; but it is equally important that the relationship does not become overly cosy. *"The Chairman must not be captivated by the CEO"* observed one Director, whilst a member of one unsuccessful Board reflected that the Chairman had become *"a cheerleader for management…part of the atmosphere of self-congratulation and hubris"*. In the most successful relationships, the relationship is perhaps '80% supportive/20% challenging' with the robust exploration of differences between the Chairman and the CEO but ideally in private and ahead of Board discussions, rather than in open forum.

- <u>*Frequent and open communication:*</u> Finally, the relationship needs to be built through frequent and informal interaction, not just through more formal 'set piece' sessions. One CEO talked of the value of *"almost instantaneous communications"*, whilst another welcomed the frequent informal discussions with his Chairman that both helped to build their relationship as well as to provide valuable real-time insights and advice. Above all, communication needs to be characterised by openness, honesty and candour – no surprises either way.

Whilst the relationship between the Chairman and CEO is critical, it is not the only relationship on a Board that needs to work well. It is also important that that there is effective balance between the CEO and the top executive team – including, but not restricted to, the Executive Directors. There is always the potential for the CEO to become too dominant a figure, partly because (as one Chairman put it) *"most CEOs are control freaks; it's part of what makes them successful"*, but also because of the growing trend in recent years that many Directors referred to of CEOs being built up in the press into 'celebrity' figures. Non-Executives need to be alert to the danger of an overly powerful CEO: one Director of a business that failed observed that a key factor was *"a dominant CEO who went for executives in front of others and created a culture of blame and fear"* whilst another observed that *"nothing grows in a big freeze"*.

Given that most Board failures have at their heart weaknesses in the performance of the Executive team, Directors need to ensure that there is a healthy culture in the top team, that people feel they can speak out openly and that that the right people are in the right roles; equally, they need to be alert to the danger that they may be getting only one black and white view from the Executive team, rather than seeing the inevitable shades of opinion that are likely to exist. The Chairman and his or her Non-Executive colleagues therefore need to monitor dynamics and body language in the Boardroom carefully to look for signs of a lack of openness, to ensure that Executive Directors are encouraged to contribute fully as Board members, and to develop direct links – through Committee work and more informal interactions – with senior executives.

Equally, there needs to be balance amongst the Non-Executives. The Chairman needs to work consciously on avoiding the development of cabals: this requires spending time outside of Board meetings with each Director, updating them on key developments and understanding any concerns they may have, rather than focusing in particular on an inner coterie of Committee Chairs or specific favourites. It also requires ensuring that key decisions are genuinely taken in Board meetings, rather than being 'pre-baked' ahead of time by an inner group. At the same time, the Non-Executives need individually and collectively to play a highly engaged role that ensures that the Board doesn't become *"the Chairman and CEO show"*.

4. **Being a great NED is as much about character as competence**

Non-Executive Directors need of course, individually and collectively, to bring the skills and business experience required to execute their role in light of the particular challenges and priorities facing the business. Well-run Boards now identify these skills systematically and review where any gaps may exist. However, having such skills is a necessary but not sufficient condition for Board effectiveness; it is equally important that the Non-Executive Directors have the necessary character for the role. One Director summed it up well: *"Personal attributes such as motivations, values and behaviour are ultimately more important than technical skills and experience"*. Our research highlighted five broad areas of character that are critical – the '5 Cs':

- *The right catalyst or motivations:* When you ask Directors why they join Boards as Non-Executives, the answers usually centre on the intellectual stimulation they gain and the chance to make a difference to an interesting business. Nevertheless, it was interesting that when Directors were asked why some of their colleagues wanted to be on Boards, a variety of less noble motivations were suggested. For a minority, money was felt to be important – those with broad portfolios or from a non-business background for whom the fees represented a more significant source of income. For many, status and the desire to stay connected following the end of their Executive career is critical: one interview talked of colleagues with *"fear of the vacuum – both intellectually and socially"*, whilst another talked of the need to *"have a good answer to the 'what are you doing now' question at dinner parties"*. One Director admitted *"I couldn't bear the thought of being on the outside looking in…my work is my life"*. Such motivations are not necessarily dangerous, but it is important for the Chairman to understand and monitor them – so that he is confident that at all times Directors have high levels of integrity and are putting the institution ahead of their own self-interest. *"This is much rarer than I used to think"*, one seasoned Chairman observed.

- *Commitment and engagement:* A high degree of commitment and engagement is non-negotiable. Certainly, the role of a Non-Executive has become a much more serious one in recent years and it is typically taken very seriously. At a minimum, Directors need to prepare thoroughly for meetings by reading the board papers and to execute diligently the Committee work. Equally, however, they need to deepen their insights on the business by involved outside of formal meetings, exploring opportunities to add value to the Executive team in specific areas of expertise. Above all, they need to have the knowledge required to ensure that their counsel reflects the specific facts of each situation, not just their previous corporate experience.

- *A challenging and independent mindset:* To be effective, Directors need to bring a challenging mindset – the ability and willingness to ask awkward questions and to test management's thinking, rather than to be sycophantic and compliant. As one CEO put it, "*you want people who will make you stop and think*"; another complained that *"Boards typically have one or two tame dogs that just waste a seat"*. In the same vein, one Chairman spoke of the need for *"independent directors, acting independently"* and observed that *"compatibility is important, but so is contrarianism"*. Several international Directors pointed out that British Boards can become overly polite, and whilst it is the Chairman's role to create an environment of robust discussion, it is critical for Non-Executives to take full advantage of this.

- *A collaborative and constructive style:* At the same time, however, Non-Executives need to contribute in a constructive and empathetic way. Successful Directors avoid long-winded speeches, ensure their comments are evidence-based rather than mere assertions, demonstrate active listening rather than dominating airtime and avoid grandstanding. *"It's not about showing how smart you are and how weak management is"*, said one Director, whilst a Chairman commented on the need to *"avoid arrogance and the over-valuing of your own ego"*, adding that the best Directors are "*good listeners who don't have something to prove, not jumped up traffic wardens*". *"You have to avoid the 'wannabe' CEO or the former CEOs who think they know everything"*, said another. Experienced Directors talked of the need to have the maturity and wisdom to read situations, the empathy to look at issues from the shoes of the Executive team, the subtlety to judge when to dive in and a questioning, rather than telling, style. Above all, discussions and disagreements should centre on issues not personalities, and remain focused on problem-solving and not apportioning blame.

- *Courage under fire:* Finally, Directors need to have courage. This takes many forms. Firstly, there is the courage to swim against the tide and to express a contrary point of view, rather than meekly to follow the majority point of view – what one Director called "*the integrity to speak out with conviction*". Secondly, there is the courage to remain entirely focused on what is right for the business and its stakeholders, rather than worrying about the external reaction – in particular in the media. A surprising number of Directors are thin-skinned and overly concerned with what the press think – and hence the perceived impact on their reputation – and consequently try to manage the optics of the situation; the most effective Directors instead "*have the balls and the backbone to ignore these siren voices…and don't run at the first whiff of gunfire"*, argued one Chairman. Finally, Non-Executives ultimately need the courage to resign from a Board. This option should clearly be the last resort, but is one utilised arguably too infrequently, perhaps because Directors wish to avoid being labelled as 'members of the awkward squad' and damaging their relationships on or prospects for other Boards. But as one Board veteran argued *"you've got to stand up for what you believe in…and you've got to be prepared to go if necessary"*. The words of Theodore Roosevelt in Paris in 1910 are apposite: *"The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood…[not] with those cold and timid souls who know neither victory nor defeat"*.

The value of these elements of character raise an important implication for the selection process itself, as they clearly need to be explored just as thoroughly as candidates' technical qualifications. As well as through skilled probing in interviewing, assessing such character traits can best be done through thorough referencing of candidates with colleagues from other Boards and organisations; past behaviour, especially in difficult and challenging situations, is a strong predictor of future actions. A number of Directors observed that referencing can often lack the rigour and insight required on these dimensions, and that Chairmen should both insist on better referencing and be prepared to take up certain references directly themselves.

5. <u>**The Board needs to be designed and managed as a high-performing team:**</u>

The best Boards function as high-performing teams, and it is incumbent on the Chairman consciously to try to create the right conditions for this. Team effectiveness is an area of extensive broader analysis and perhaps unsurprisingly our own research underscored the importance of many of the key generic findings. Six key characteristics were highlighted:

- <u>*Building a common purpose:*</u> The starting point for any high performance team is clarity and alignment on its purpose and Boards are no different. The best Boards therefore explicitly address fundamental questions on the nature and focus of their role and how they will add value to the business – in key areas such as governance and risk management, strategic direction-setting, performance oversight and succession planning. Alignment on this should then underpin how the Board operates – influencing the frequency and nature of its meetings, how it spends its time and the way the Board interacts with the broader organisation. Importantly, this agreement on the Board's purpose should not be a one-off exercise, but instead periodically revisited in the light of changing circumstances. This may sound obvious, but it is surprising how rarely Boards have systematically thought these issues through.

- <u>*Optimising Board size:*</u> General research suggests that teams of 8-12 are optimal in balancing the trade-off between the need for sufficient resources and the ability to maintain cohesiveness. It is unsurprising therefore that the value of keeping Boards as small as practically possible was an almost universal observation from our interviewees. Some suggested 8-10 was best, others 10-12 – and all recognised that the scale and complexity of the business was an important influencing factor. Nevertheless, they stressed time and again the disadvantages of Boards that were too big and the deleterious effect they had on the quality of discussions and the degree of mutual commitment. "*Every time you add someone to the group, you multiply the relationships binomially*" observed one Chairman, whilst another added "*with each new member, the signal to noise ratio decreases*". The desire to keep Boards small argues for relatively restricted formal Executive Board membership and many of our interviewees argued strongly for only having the CEO and CFO on the Board; however, others felt equally passionate about the value of broader membership.

- <u>*Ensuring mutual respect and commitment:*</u> For a Board to work well there needs to be a strong foundation of collective commitment. This foundation comes from three elements. Firstly, there has to be mutual respect: the Non-Executives need to have confidence in the management team and equally the Executives need to see the Non-Executives as capable of adding value: as one Chairman argued, "*the calibre of the Board must be good enough to warrant and command the CEO's respect*". Secondly, there needs to be a bedrock of common values that provides a degree of glue to the Board. Thirdly, and perhaps most importantly, there needs to a high degree of trust in the confidentiality of Board discussions and an unwavering adherence to the idea of cabinet responsibility. At its best, the unitary Board model facilitates this extent of mutual commitment, but it requires careful and unrelenting management by the Chairman to create and maintain it.

- *Engineering diversity – especially of thought patterns:* Boards need a shared purpose, common values and mutual commitment. However, at the same time they are only truly effective if they bring and embrace divergent thinking. As one Director put it *"diversity leads to dynamism, similarity to staleness"*. Diversity takes many forms. Clearly, a range of skills and experience is critical to bring both the expertise required and to enable different perspectives to be accessed; most CEOs agree that having one or more serving executives alongside seasoned retired Executives is invaluable. Having a range of nationalities brings interesting cultural diversity as well as different geographic experiences. Female Non-Executives often bring a less ceremonial, more open and empathetic style and can reduce the tendency to 'Alpha Male' grandstanding; they remain significantly underrepresented on most Boards. All these dimensions of diversity are important, and most strong Chairmen are consciously working on them. However, there is one further dimension which is both critical and in our experience often undermanaged and that is the need to have a diversity of cognitive thinking types on Boards – seen by one Chairman as *"the most important defence against groupthink"*. Getting the balance right between the chemistry of a harmonious Board and the productive edge of one with robust discussions is a real art, and the best Boards have one or two members (carefully nurtured by the Chairman) who provide grit in the oyster.

- *Investing in team-building:* Furthermore, Chairmen have to work at turning the Board from a working group into a real team. This rarely happens naturally through the rhythm of formal Board and Committee interactions. Instead, a range of mechanisms needs to be used that build closer professional and personal bonds. The best Boards are typically characterised by the use of Board dinners, Strategy Awaydays and foreign visits that not only provide important fora for professional interactions but also help forge closer ties and underscore the sense of shared commitment. As one Director put it *"relationships matter…the Board needs a social identity"*. In addition, the most effective Chairmen work hard at keeping all Directors in touch with events so that they feel, as one said, *"Board members every day not just in formal meetings"*; this is enormously helped by modern technology.

- *Addressing weak links:* The final element is one that many Chairmen find the hardest – addressing underperformers or people who are a destructive or malign influence. No-one likes to take lightly action that may raise questions or damage someone's reputation – or indeed that may lead to concerns from shareholders on how the Board is functioning. There has historically therefore been a preference to allow people to serve out their term, rather than taking more specific action. However, this can be dangerous: as one Director said *"You really need to deal quickly with the bad penny…They can poison things"*. One side benefit of the move in the revised UK Combined Code to annual election of Directors is that it may embolden Chairmen to deal more decisively with these issues. In the meantime, the most successful Chairmen explicitly invest significant time in developing Board members to help maximise their effectiveness, both through the provision of training as required and through personal coaching.

6. **<u>The best Boards make skilful use of a range of 'safety valves':</u>**

Our research also highlighted that there are three key 'safety valves' that can be invaluable in surfacing and addressing key issues inhibiting Board effectiveness – but that equally can be at best window-dressing and at worst potentially dangerous if used poorly. These are the role of the Senior Independent Director; formal Board Effectiveness Reviews; and the support of the Company Secretary.

- *<u>The Senior Independent Director (SID):</u>* The introduction of the role of SID was one of the major innovations resulting from the Higgs Review. However, opinions of the value it has added remain surprisingly mixed, not only from Chairmen but also from other Directors. At its best, it represents an important safety valve for Directors to raise concerns about the way the Board is operating – issues that they may feel uncomfortable raising with the Chairman or that he or she may not be listening to. Equally, the SID can offer a route for investors to raise concerns about strategy, board dynamics or Chairman and CEO performance if they feel their voice is not otherwise being heard. However, too often the SID has not proved to be this constructive force. In some cases, the SID has been seen as too close to the Chairman and therefore not capable of offering the necessary challenge; in others, the role has instead sown the seeds of the creation of an alternative and disruptive power base on the Board. To ensure that the SID works as effectively as possible, there are four key lessons to bear in mind:

    - Beware the SID with ambition: it is vital that the person selected to be SID lacks – and is seen to lack – any appetite or aspiration for the Chairman role.
    - Ensure the SID is independent: the role must be played by someone who is in no way beholden to the Chairman; it is important that the process for appointing him or her is transparent and involves consultation with all Board members.
    - Look for a mixture of diplomacy and backbone: the best SIDs combine the emotional intelligence to pick up on issues, the judgement and diplomacy to address them in a balanced and non-threatening way and the strength of character to be persistent in ensuring concerns are dealt with.
    - The role is essentially a reactive one: on a well-functioning Board the SID will have little or nothing to do – and should be entirely comfortable with this – although the practice of Non-Executive only dinners at least once a year provides a useful forum to raise any issues.

- *<u>Board Effectiveness Reviews:</u>* Annual reviews have been mandatory for several years now in the UK, but are often seen as mere box-ticking exercises, conducted to meet the Combined Code's requirements. This is particularly true of internally-led reviews – and up to the end of 2009, 42% of the FTSE 100 companies had only ever conducted internal reviews. However, it is also unfortunately true that many externally facilitated reviews have also had little impact; one Director talked of *"exercises which get you to first base, but no further"*. In contrast, though, a number of the interviewees talked of assessments that highlighted important issues and provided the basis for the Board to agree real changes to the way they operated – *"a real catalyst"*, said one Director. The most effective reviews seem to have had a number of common characteristics:

- They are facilitated by experienced and confident evaluators, who combine deep and broad boardroom experience with the independence of mind to draw out difficult messages.
- They centre on individual interviews. The issues are too complex and too sensitive to be dealt with via questionnaires; individual confidential interviews provide the best way to surface and explore key issues.
- They are focused on the right issues. Too often, reviews focus simply on assessing the Board's modus operandi and recommending incremental changes to its processes and procedures; instead reviews should start by ensuring clarity and alignment on the role of the Board, how it will add value and whether it has the capabilities required, before exploring not just how its processes operate but also the more subtle but pivotal behavioural dynamics.
- They are driven by a commitment to action. It is vital that a review clearly stimulates the discussion of a series of concrete actions to improve Board effectiveness, rather than just being a paper exercise. The report should propose sharp and actionable recommendations, and the Chairman needs to facilitate and lead an open, honest and courageous conversation that develops and commits to a concrete set of actions to address the identified priority improvement areas.

- *<u>The Company Secretary:</u>* The third and final potential safety valve is the Company Secretary. Experience and hence opinions on the contributions that Company Secretaries varies widely, and there is no doubt that some holders of the role focus merely on supporting the efficient operation of the Board and related processes. The best Company Secretaries however play a critical role as an invaluable source of counsel and advice to not only their Chairmen but also the other Directors, and as an important neutral sounding board on issues that are emerging. One Chairman described his Company Secretary as *"my second set of eyes and ears on the business and its dynamics"*.

7. **<u>Anticipating and managing 'red flag' issues is the acid test</u>**

Finally, it is important to recognise that even the most successful Boards can go off the rails. The best Chairmen and the best Directors are constantly alert to potential dangers; our research highlighted three key 'red flags' to look out for:

- *<u>The corrosive influence of power and success:</u>* CEOs – and indeed Chairmen – who start out in their roles with a well-balanced outlook and a willingness to listen can, over time, become gradually but progressively less tolerant of challenge, less effective at taking advice and more influenced by what one Director described as the *"folie de grandeur"*. Boards need to be alert to this risk, watching out in particular for changes in behaviour. Danger signals can include the stifling of debate in the Executive team, the loss of strong talent in the senior ranks, a lack of effective succession options and a reluctance to engage in rigorous succession planning; similarly, a less open and collaborative degree of engagement with the Board is a concern. It is interesting that several of the newer CEOs have brought with them an encouragingly open and constructive approach to working with their Boards, often in marked contrast with their predecessors; it will be interesting to see if this endures.

- *Self-congratulation and hubris:* Boards of successful businesses risk falling into the trap of not stress-testing their thinking and anticipating changes – both internal and especially external – that can disrupt their progress. A particular danger is that the Board becomes a victim of 'group think' and fails to bring the necessary degree of challenge to the Executive team. One Director talked of the risk of becoming *"enthralled by management"*, whilst another admitted that a Board he had been on had been guilty of *"walking over the cliff applauding the CEO"*. Boards need to guard against this – in part through the right composition and refreshing the Board, but also through having a healthy degree of paranoia and developing mechanisms that force a rigorous assessment of the risks and the potential disruptive forces out there.

- *The personal drama of succession events:* Above all, Boards need to be aware of the destabilising impact that Chairman and CEO succession can have – not just because they end with new characters in the pivotal roles, but even more so because the succession process itself offers great scope for people to reveal themselves at their worst. As one Director put it, *"these big decisions are always the proving points for Boards"*. Another explained people's behaviour as they prepared to step down from their roles thus: *"Work is their life…They have horror at the sight of the finishing line and the prospect of losing their identity, their car and their secretary"*. Contenders for roles may even seek to play out their candidacies through the press, on occasion going so far as to hire their own PR advisers.

  The best Boards deal with this in part by insisting on robust succession plans and timetables. As one Director argued *"No-one's irreplaceable, but Chairman and CEOs can't see their own moral hazard";* it is vital that the Non-Executive Directors ensure that robust discussions on succession planning and timing are had, that appropriate plans are put in place and that they are stuck to. Boards should also invite the SID to play the lead role in Chairman succession processes; whilst the outgoing Chairman should play an important role in starting the process, the SID (providing he clearly has no designs on the role) is then pivotal in ensuring that the integrity of the process is maintained throughout. *"Even with well-intentioned Chairmen, personal fears and concerns can distort their behaviour"*, observed one seasoned Director. The SID and his fellow Directors are the ones who will live with the consequences of the decision taken; the outgoing Chairman should therefore not be allowed unduly to influence the choice made.

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Behavioural dynamics can make the difference between a bad Board and a good Board and between a good one and a great one: our own experience and that of the 70 seasoned Directors who took part in our research confirms this. This report highlights seven key areas for Boards to consider. We believe that recognising these issues and managing them correctly should provide the foundation for ensuring that a Board develops the right behaviours and hence enhances its effectiveness. We hope this provides useful food for thought to all Chairmen, CEOs and Directors.

Appendix 1

SELECTED BOARDS ON WHICH RESEARCH PARTICIPANTS HAVE SERVED

3i
ABB
Abbey National
ABN Amro
Aegis
Aegon
Air Liquide
Akzo Nobel
Alliance Boots
Allianz
Alstom
Amec
Anglo American
AP Moller-Maersk
Associated British Foods
AstraZeneca
Atlas Copco
BAA
Babcock International
BAE Systems
Baker Hughes
Barclays
BASF
BAT
BBA
Belgacom
BG Group
BHP Billiton
BlackRock
Booker
BP
Brit Insurance
British Airways
British Land
BSkyB
BT Group
Bunzl
Burberry
Cadbury
Cannons Group
Carnival
Cenkos Securities
Centerpulse
Centrica
Chevron
Chugai Pharmaceuticals
Close Bros
Computer Sciences Corporation
Corus Group
Daily Mail & General Trust
Deutsche Bank
Diageo
Duke Energy
EADS
EasyJet
Electrolux
Enterprise Oil
Equant
Ericsson
ESG RE
Euromoney
Experian
Fedex
First American Corporation
Fluor
Ford
Friends Provident
Gap
GDF Suez
Genentech
General Mills
George Weston
GKN
GlaxoSmithKline
Great Portland Estates
Greene King
Hammerson
Hanson
Hays
HBOS
Hess Corporation
Hogg Robinson
Home Retail Group
HSBC
Hub Power Company
Husqvarna
IMI
Icap
ICI
Imperial Tobacco
Inchcape
International Power

Invensys
Investor AB
Jardine Lloyd Thompson
Jones Lang Lasalle
JP Morgan
Kedge Capital
Kerr-McGee Corp
Kingfisher
Laporte
Lastminute.com
Lattice Group
Leeds United
Legal & General
Lloyds Banking Group
Loblaw
London Stock Exchange
Low & Bonar
Lupus Capital
Man Group
Marks & Spencer
MEPC
Mitchells & Butlers
Mondi
Morgan Crucible
Morrisons
Nalco
National Australia Bank
National Grid
National Power
Nikko Cordial
Nomura
Northern Foods
Northern Rock
Novar
NYSE Euronext
Old Mutual
Parker-Hannifin Corporation
Pearson
P&O
Petrofac
Peugeot
Philip Morris International
Powergen
Premier Oil
Prosiebensat1 Media
Prudential
Qantas Airways
Rank
RBS
Rea Brothers Group
Reckitt Benckiser
Reed Elsevier
Rentokil
Rexam
Rexel
Rio Tinto
RMC
Roche
Rolls-Royce
RSA Insurance
SABMiller
Sage
Sainsbury
Sara Lee
Scania
Schlumberger
Schroders
Scottish Power
Serco
Severn Trent
Shell
Siemens
Skandinaviska Enskilda Banken
SKF AB
Smith & Nephew
Spectra Energy
Stagecoach
Standard Bank
Standard Chartered
Standard Life
SVG Capital
Syngenta
Tata Steel
Telstra
Tesco
Tesoro
Thames Water
Thomson Reuters
TNK-BP
Trinity Mirror
UBS
Unilever
United Business Media
United Utilities
Vodafone
Wincanton
WPP
Xstrata
Yule Catto
Zurich Financial Services

Appendix 2

ABOUT MWM CONSULTING

MWM Consulting is a leading Board advisory and search firm and acts for a number of the largest companies in the world, both in the UK and internationally. In the UK, we have supported the appointments of over 15% of the current FTSE 100 Chairmen and CEOs; a third of our work is for similar global enterprises based outside the UK and during the last two years we have supported Board appointments in markets across North America, Europe and Asia. MWM partners have been involved in the appointment of more than 600 serving Non-Executives worldwide; 65% of our Board appointments have been of non-UK citizens.

In addition, MWM advises on Board performance, capability and succession planning. We were a pioneer in the UK of Board Effectiveness Reviews and have consistently been an innovator in the focus of such reviews, drawing not only on our Boardroom search and consulting experience but also proprietary insights and perspectives from our ongoing research programme. In recent years we have conducted Board Reviews for over 10 FTSE 50 businesses as well as for similar companies abroad and a range of smaller enterprises and not for profit organisations.

This research into Board Behaviours was led by three of our partners:

- *Michael Reyner* joined MWM Consulting in 2007 and has led a range of Board assignments, including both effectiveness reviews and Board appointments. Before joining MWM, Michael was at McKinsey for 15 years where he was one of the partners leading the European Consumer practice.

- *Anna Mann* was one of the founders of MWM Consulting in 2002, and previously was the founder of Whitehead Mann. She has worked with the Boards of leading businesses around the world for over 20 years.

- *Richard Phillips* joined MWM in 2004, having previously worked in the Board Practice Group at Whitehead Mann. Prior to this, he spent three years covering professional and financial services with Whitehead Mann.

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