SpencerStuart

# Boardroom BEST PRACTICE

Lessons learned from board assessments across Europe

# Contents


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### Boards Around the World

An interactive exploration of how boards around the world compare in terms of diversity, composition, compensation and more.

# Introduction

Companies are facing an uncertain and disruptive business environment. Rarely has the role of the board been more important in steering a company through challenging times.

Spencer Stuart has been advising the boards of Europe's leading companies for several decades. As a result of our advisory work, board assessments and regular interactions with business leaders we have accumulated a significant body of knowledge about what makes an effective board.

In this third edition of *Boardroom Best Practice* our purpose is to share our knowledge by identifying common areas of best practice among European listed company boards. We offer here a set of practical recommendations that boards can apply regardless of the different cultural and legal frameworks in which they operate. Indeed, if we have learned one thing it is that board effectiveness is enhanced by applying these principles, whether the board is unitary, two-tier, predominantly executive or operating under the umbrella of a majority shareholder.

We seek to provide a framework through which best practice can be identified and tailored to a specific board's needs. We also present behavioural and regulatory differences at a national level as a series of sidebars that accompany the text. Our aim is to help directors and board chairmen and women[1] to understand

1 Hereafter the term chairman is used to include any gender.

how changing business requirements and thinking about governance affect board practice.

The nature of board debate and decision-making, as well as the management of stakeholders' interests, is in flux. To keep abreast of developments we will periodically update this publication, building on our experience and sharing new lessons learned.

Few endeavours are more fulfilling than serving on a board. Directors operate at the interface of public and private morality and their accountability goes well beyond their duties to employees and shareholders. They are encouraged to elevate the long-term interests of all stakeholders above short-term considerations, even though as a consequence it can be difficult for a board to satisfy the needs of all who have an interest in the company's success.

The level of engagement expected of directors is increasing and we believe this is a good thing. To be a successful director today should be an absorbing intellectual and practical challenge. We hope *Boardroom Best Practice* will help you rise to that challenge and add to your enjoyment of the role.

# What good governance looks like

What constitutes good corporate governance and proper board behaviour is constantly changing. Governance changes once came about mainly in response to crises, but continuous improvement is now the watchword, mirroring developments in the societies that companies serve.

However, it is not the job of codes or regulations to provide a straitjacket that inhibits a board's vision and stifles the entrepreneurial spirit of the business. Boards have considerable discretion and should always be judged on how they exercise it.

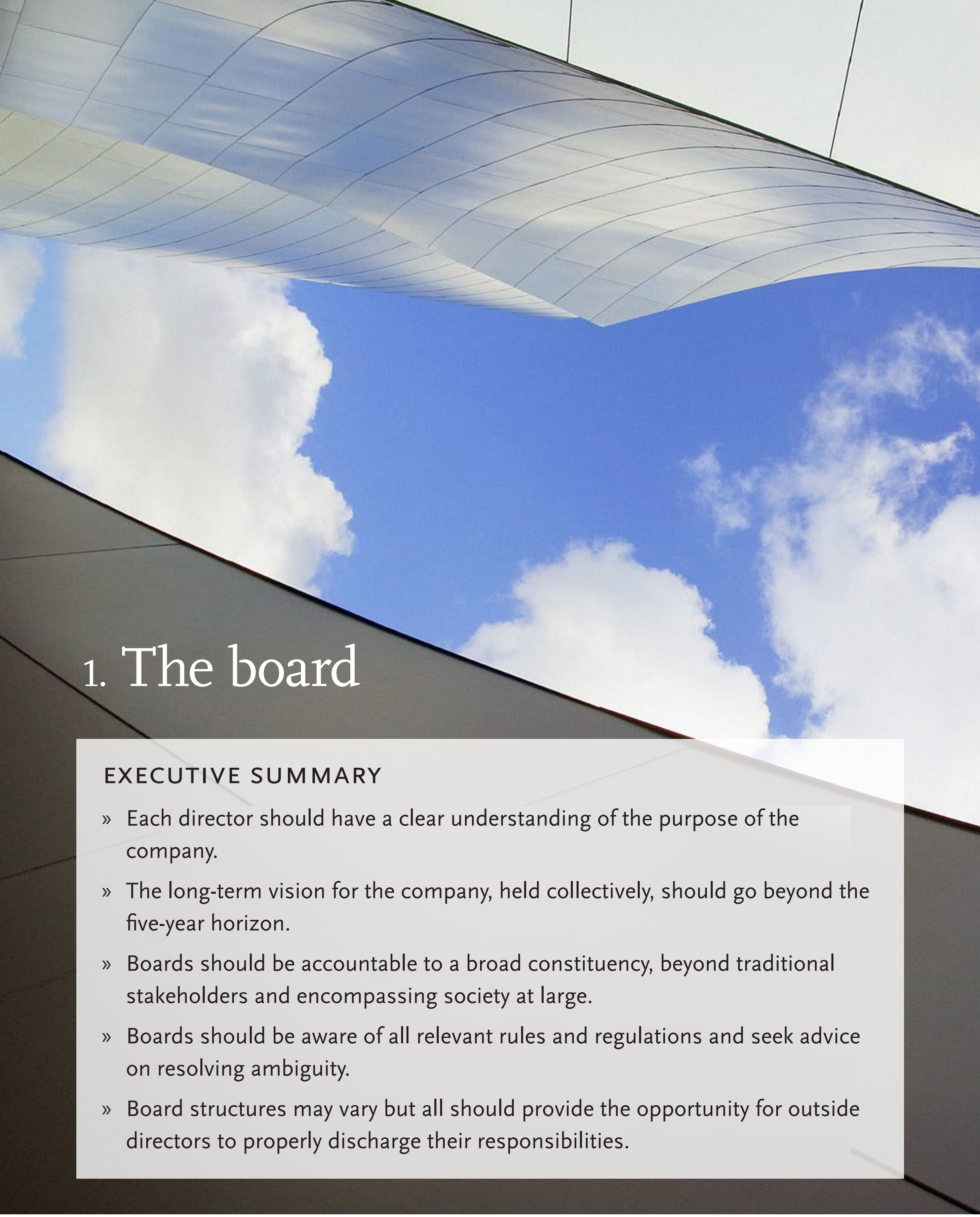
So, whilst there is no universally applicable definition of what makes for an effective and successful board, we would characterise the hallmarks of a successful board as follows:

- Clear definition and understanding of the role of the board and how it differs from that of the management team
- Wise and sensitive leadership that fosters productive and challenging debate
- Appropriate composition of directors, all of whom are aligned with the long-term strategic vision
- Active involvement of all directors
- Thorough understanding of how the company makes its money
- Confidence in the competence of the senior management team at all times
- Efficient decision-making processes

- » Trusting and open working environment
- » Clearly defined remits for committees and effective communication between each committee and the board
- » Regular assessment of individual and collective performance
- » Maturity of vision and shared understanding of the company, its culture and purpose
- » Commitment to transparency and open communications with all stakeholders
- » Commitment to honouring the recommendations of relevant governance codes
- » Willingness to articulate and justify the role of the company in society.

Any board that exhibits all or a majority of these characteristics can be counted both a success and an enjoyable institution on which to serve.

What follows is an exploration of the conditions, practices and behaviours that foster the kind of success to which the best boards aspire.



# 1. The board

## EXECUTIVE SUMMARY

- Each director should have a clear understanding of the purpose of the company.
- The long-term vision for the company, held collectively, should go beyond the five-year horizon.
- Boards should be accountable to a broad constituency, beyond traditional stakeholders and encompassing society at large.
- Boards should be aware of all relevant rules and regulations and seek advice on resolving ambiguity.
- Board structures may vary but all should provide the opportunity for outside directors to properly discharge their responsibilities.

## 1.1 Purpose

The board of directors developed as a means of capturing wisdom and experience and applying these to problems faced by the organisation at large. The board is where power and authority lie and where responsibility and accountability are to be found. It is a mechanism for synthesising the views of a range of experts who exercise collective responsibility in the long-term interests of the business.

The codes and laws governing board behaviour differ by jurisdiction and the regulations and legal structures under which they are created vary from country to country. Nevertheless, all boards essentially have the same purpose.

As a minimum, that purpose is to accomplish the formal objectives set out in the company's foundation documents. Board directors do this by utilising the powers vested in them by those foundation documents and by law and regulation. In exercising these powers they should attempt to balance the legitimate interests of all stakeholders, both inside and outside the organisation.

## 1.2 Responsibilities

Specific board responsibilities vary according to jurisdiction and the prevailing board structure. The responsibilities of a unitary board in a UK company are subtly different from those of a supervisory board in Germany, for example. Regardless of governance structure, the key responsibility of all boards is to balance the interests of the company, shareholders and other stakeholders by ensuring long-term growth that is sustainable and profitable. This involves oversight of the executive through ongoing active questioning, constructive challenge and support. Specifically:

### PERFORMANCE

To support the CEO and management in establishing the optimal strategy for the business, to monitor the implementation of that strategy and to challenge and support the executive in the discharge of their duties.

### SUCCESSION

To take full responsibility for the board's own succession including that of the chairman and the CEO, and to ensure that the company has appropriate systems in place for effective succession at senior-executive level.

### COMPLIANCE

To ensure that the business meets all its regulatory obligations, whether structural, behavioural or financial, and to secure the confidence of investors by upholding the highest standards of corporate governance.

### RISK MANAGEMENT

To understand the financial, operational and reputational risks faced by the company and the sector in which it operates, ensuring that all necessary measures are taken to mitigate and control those risks.

## REPUTATION MANAGEMENT

To have an understanding of and explanation for all decisions and actions taken by the company, ensuring these are properly communicated, whether the company is in crisis or not.

## SOCIAL IMPACT

To set the tone at the top of the company, to understand the company's place in society and to provide the executive with the external perspective — "bringing the outside in." To recognise that regulatory compliance may not be enough to satisfy ethical expectations.

This is not an exhaustive list. However, we believe that no outside director can properly fulfil his or her many responsibilities without deep knowledge of what the company does and an emotional commitment to how it does it. The most effective director is both the representative of the stakeholders and an ambassador for the business.

## 1.3 The long term

By looking after the long-term interests of the company, directors can foster an environment that creates sustainable value for all stakeholders.

Short-term thinking stifles the ability of company boards to make the bold investments in the future that will secure the long-term health of the business, which is the board's ultimate responsibility.

A long-term vision for the business is a necessary precursor to the development of strategy, guiding the board and management as they look beyond the five-year horizon.

### Is the board focused on the long term?

We recommend that boards ask themselves the following questions:

» Does our board understand the need for a long-term vision?

» How clearly can the directors articulate the long-term vision and values of the business?

» How engaged is our board in debating strategy with management, or is it handed down as a fait accompli?

» To what extent do we cultivate long-term investors and explain our vision for the business to them?

» Does our board seek outside advice on critical issues?

» Are all the directors required to have a long-term stake in the business?

» Do we assess whether new director candidates will uphold the long-term vision of value creation for the business?

If long-term considerations are going to prevail over short-term interests, then the board has to be bold and courageous in exercising its collective responsibility, setting the tone for the business to think about its mission in a different way.

Directors do not have to accept that their hands are tied, that they are there to do the bidding of shareholders who may be only fleetingly involved with the company. They can make a difference by committing themselves more deeply and exclusively to the business and by ensuring that all board activities and interactions with management and investors are underpinned by a clear understanding and articulation of the organisation's long-term vision and values.

## 1.4 Accountability

Historically, most boards of directors did not feel the need to answer to anyone beyond the owners of the business, and indeed owners and directors were sometimes the same people. Over the years, however, boards have become accountable to an ever-growing list of stakeholders.

While shareholders were usually the original constituency to whom obligations were owed, these constituencies have expanded to include, at a minimum, employees and customers. More recently, the social impact of a company's operations, both negative and positive, has meant that all boards must take account of any group or individuals who might be affected by corporate action, regardless of whether or not such persons are in a direct relationship with the company. So, suppliers, regulators, non-governmental organisations (NGOs), lobbyists, academia, potential recruits, etc., all extend the list of stakeholders.

Beyond this, boards are expected to be aware of the company's overall social impact and to justify and defend their activities in terms of the public interest, not just that of the owners.

## Accountability and responsible business

In most markets boards are deemed to be accountable to the shareholders at the General Meeting. However, in all markets local company law addresses accountability and has different emphases. Usually the definition is broadened to include a selection of other stakeholders, i.e. people to whom the company can be seen as owing a duty or people who depend upon it in some other way.

For example, in Italy, there is more emphasis on accountability to the controlling shareholders, and in countries where there are employee representatives on the board, these are also accountable to their employee electorate. In Norway, the board is accountable to the company, which includes not only shareholders and owners, but also creditors, employees and others. In the Netherlands, the board is accountable to all stakeholders. In the UK, the board is accountable to the shareholders and the company itself, although it is obliged to have a broader constituency in mind.

Thus beyond existing codes and law, there is general acceptance of the concept that companies have obligations beyond just shareholders and the requirement to produce profit.

Originally, obligations were largely owed to owners, promoters and those who had invested in the success of the business for reward. Growing recognition of social market pressures then led many jurisdictions to expand the list of interested parties to include "stakeholders" and those on whom the company relies for its wider success, e.g. employers, customers, local communities, etc. Today's concern seeks to establish whether companies and directors owe obligations to society at large in return for their licence to operate and, if so, what these might be.

## 1.5 Regulation

Boards do not operate in a vacuum, insulated from the pressures of accountability. Both law and regulation delineate what they can and cannot do and how they should go about their work.

Once upon a time, there was only the law. Both civil codes and common law set out the duties of directors in limited form. Founding shareholders and owners were supreme and as for the interests of subsequent investors it was a case of "caveat emptor". Other stakeholders had not yet been identified, nor their interests protected.

In recent years, the law has been deemed insufficiently comprehensive to regulate all aspects of corporate behaviour. More importantly, it lacks the flexibility to be changed quickly to deal with emerging responsibilities or abuses and with the evolving pace of public expectations.

Consequently, authorities have turned increasingly to regulation and codes of conduct to guide board behaviour. Sometimes they have promoted self-regulation but results have been mixed.

Most national governance codes are based on the principle of comply or explain. Whilst reasonable, the principle's effectiveness depends on the quality of the explanation in the event that a company does not comply with a recommendation. Given that most codes are largely silent on what comprises a proper explanation, the adequacy of comply or explain is an issue for the outside director to consider carefully.

A particular challenge for directors is the proliferation of codes of conduct and best practice recommendations at investor, regulator, national and supranational level. Corporate governance is now both an industry and a field of academic study. Directors will need professional guidance to understand the sometimes conflicting signals coming from these many sources.

## 1.6 Structures

In this publication we identify those aspects of being a director that are common to all types of boards, but especially those of listed companies. However, different governance systems operate throughout the world and have created a range of different board structures.

It is important to remember that the dynamics of the board and the role of the outside director will vary to reflect what type of board structure is in place. The role may also be slightly different in state-owned or in family-controlled businesses.

In Europe, two forms of board structure predominate: 1) unitary or single-tier, in which supervision and management are combined in a single body; and 2) supervisory or two-tier, in which supervision and management are respectively assigned to separate bodies. The responsibilities of a supervisory board are necessarily fewer, lacking the management dimension.

### UNITARY BOARD

A unitary board consists of a chairman, outside directors and at least one representative of management. Within this basic model there are many variants:

- In some countries, one individual performs both the chairman and CEO roles
- Unitary boards often have a senior independent director or equivalent
- Independent directors are usually in the majority
- Some outside directors may not be independent
- Management may be represented by the CEO as well as other executives
- Day-to-day management of the company is handled by a senior executive team often referred to as the executive committee, appointed by and responsible to the CEO.

## SUPERVISORY BOARD

A supervisory board consists of a non-executive chairman and outside directors. Some jurisdictions have co-determination laws governing board composition, meaning that up to 50 per cent of board members must be employee representatives elected by employees. In the two-tier system, the management function is in the hands of a separate legal entity, often referred to as the executive board, which is chaired by the CEO and overseen by the supervisory board.

In some countries, for example France, Italy and the Netherlands, company law permits companies to choose between two or even three alternative board structures.

Family-controlled businesses, state-owned enterprises and cooperatives often have board structures that reflect their unique circumstances. This means that they can conform to listed company governance requirements where relevant but choose to ignore them when not.

The role and responsibilities of the outside director in an organisation where there is a majority shareholder are not materially different from those of a director in a listed company with a broad shareholder base. However, they may be harder to execute and properly discharge, and require direction and determination to maintain true independence.

All structures should provide the opportunity for outside directors to properly discharge their responsibilities, with protections in place for them in the event of dispute. This should be a comfort to board members, who of course can always exercise the power of resignation.

Larger and more complex companies sometimes form an advisory board, whose purpose is to provide additional specialist expertise without the legal constraints or obligations imposed on board directors.

# 2. Board composition

## EXECUTIVE SUMMARY

- The board's collective expertise should reflect the strategic priorities of the business.
- The ideal board size is eight to 12 members, except in the case of supervisory boards, which may need to be larger.
- Independent outside directors should always comprise a majority on the board.
- Regular re-election and maximum recommended terms are desirable to guarantee refreshment, monitor performance and promote transparency.
- All boards should plan to comply with local regulations on board diversity and thereby strive to avoid groupthink.
- To be effective, boards should meet at least six times a year and outside directors should be prepared to devote 20–30 days to the business and sometimes more.
- Outside directors should not be appointed to cover an executive weakness — that should be addressed at executive level.
- Directors should exhibit an emotional commitment to the company and its purpose.
- As the steward of corporate behaviour, the board should ensure that its own culture is beyond reproach.

## 2.1 Composition and appointment

Board composition is at the heart of board effectiveness. Progressive boards should frequently consider whether they have the optimum composition. Effective boards are made up of directors who reflect the strategic priorities and challenges of the business, the relevant areas of risk, and the diversity of stakeholders.

Recruiting effective non-executive board members is crucial to ensuring corporate success. The appointment of a non-executive director is not only subject to shareholder approval but to public scrutiny. Boards, and their nomination committees, must be prepared to explain their choices, demonstrate objectivity and lack of bias, and show that appointments are made purely on the basis of merit.

All board appointments must be the result of an objective and rational process, which varies from country to country. Whilst the formal appointment is made by the board and/or the shareholders, the evaluation of candidates usually falls to the nomination committee and sometimes to a committee independent of the company and its executive management.

It is increasingly the case that investors expect non-executive appointments to be mediated through professional advisors. The reasons are various. First, investors expect a transparent and justifiable appointment. Second, objectivity in the choice and how that choice is made is important. Third, bias, real or imagined, is avoided if the process is in the hands of an independent consultant. And fourth, a broader perspective is brought and specialist requirements more easily met.

In some sectors, the regulator has made rules both as to who can be appointed and how they are vetted. This is principally found in the financial services sector, where the financial regulator is responsible for setting the criteria as to the relevant experience of board candidates and for checking their career history and bona fides.

## 2.2 Board size

The size of a board is critical to its effectiveness. A board needs to be large enough to allow for a wide range of views and competencies and for each of the committees to be populated, but not so large as to prevent active engagement and participation by all directors.

In most instances, we believe that the ideal board size is eight to 12 members in a unitary board. When boards move further into double figures they become less effective: it is harder to sustain effective debate when numerous people are at the table.

Supervisory boards, however, may have to be larger than this, especially where co-determination is a legal requirement. By contrast, supervisory boards with no employee representatives often have fewer than eight directors.

The trend for unitary boards is towards less formal boards with fewer directors around the table. The boardroom is a place for debate and decision — not only for reporting and noting. Each director is expected to make his or her individual contribution.

Just as boards are more accountable for corporate actions, so directors require a closer engagement with the business if they are to carry out their responsibilities properly. The days of the purely reactive board are numbered.

### Average board size across Europe*

| | Board size | | Board size | | Board size |
|---|---|---|---|---|---|
| Belgium | 10.4 | Italy | 11.6 | Spain | 10.8 |
| Denmark | 10 | Netherlands | 9.2 | Sweden | 9.9 |
| Finland | 8.2 | Norway | 8.5 | Switzerland | 10.5 |
| France | 13.9 | Russia | 10.1 | UK | 10.2 |
| Germany | 14.1 | | | | |

* Data appearing in charts throughout this publication are taken from country-specific 2016 editions of the *Spencer Stuart Board Index*. A list of these can be found in Appendix A. Each *Board Index* is available on the Spencer Stuart website.

### Breakdown of director types in selected markets

| | NON-EXECUTIVES | | EXECUTIVES | | |
|---|---|---|---|---|---|
| Country | % who sit on one listed board only | % plural* | % serving as non-executives | % of board | Average number of directorships |
| Belgium (Bel 20 + Bel Mid) | 11.5% | 58.6% | 72.2% | 14.6% | 1.8 |
| Denmark (OMX Copenhagen) | 12.6% | 28.7% | 58.6% | 0.6% | 1.9 |
| Finland (OMX Helsinki) | 16.7% | 28.1% | 55.2% | 0.5% | 2.2 |
| France (CAC 40) | 11.5% | 32.3% | 56.3% | 8.0% | 2.1 |
| Norway (OBX) | 7.5% | 10.8% | 81.7% | 0.5% | 1.5 |
| Russia (RTS) | 3.6% | 38.0% | 58.3% | 15.8% | 1.6 |
| Sweden (OMX Stockholm) | 8.9% | 32.5% | 58.7% | 6.5% | 2.3 |
| UK (FTSE 150) | 17.9% | 48.8% | 33.3% | 25.6% | 1.9 |

* Professional board directors who do not hold an executive post.

## 2.3 Independence

Most governance codes recommend that a minimum of 50 per cent of board members should be independent from management and shareholders, with no conflict of interest. In our judgement this is truly a minimum requirement.

Ideally, all outside directors would be independent, but at the very least independent outside directors should comprise a majority of the board.

Independence is defined in various ways, but the following elements are common to most jurisdictions in Europe. Independent directors must:

- be free of commercial or personal conflicts of interest
- not be a former member of the company, at least not before any given cooling-off period
- have no financial relationships with the company or its counterparties
- have no interlocking directorships
- not serve beyond the prescribed number of years.

Obviously, a person's independent status can change. So it is good practice to review the independence of non-executive directors every year. This is often mandated in governance codes and forms a reporting item in the annual report.

Independence is not only a demonstrable fact but also an attitude of mind.

Independent thinking is essential if the outside director is to act as both challenger and supporter. The best outside directors identify clearly with the business, yet also bring an objectivity to the board's deliberations that is not possible for the committed executive.

Where there is a controlling stakeholder, or one with a significant holding, the situation can be complex. Such stakeholders can be a founding individual, a government agency, or perhaps an activist or other interloper. Sometimes, in the case of listed companies, the free float can be as little as 25 per cent of the issued equity with the balance held in family or connected hands. Such a situation requires still greater rigour on the part of the outside director to think and act independently.

A simple rule might help in such situations: the truly independent director has the interests of the company and all its stakeholders at heart. What course of action will yield the greatest chance of success for all stakeholders in the longer term?

There is currently much discussion around how boards should be constructed. In the past, the pool from which outside directors was chosen was too restrictive and a “club” atmosphere developed in some boardrooms, with extensive interlocking directorships. This risk is now well understood and today’s challenge is to create effective boards that better reflect the world in which companies operate.

Two initiatives have introduced more dynamism into board composition. First, the adoption of fixed terms has reduced the average tenure of non-executive directors and encouraged board renewal. Second, innovative measures to increase diversity have widened the recruitment pool. We now consider these in further detail.

### Independent directors as a proportion of the board

| | % | | % | | % |
|---|---|---|---|---|---|
| Belgium | 44.8% | Italy | 50.1% | Spain | 43% |
| Denmark | 66.3% | Netherlands | 60% | Sweden | 63.7% |
| Finland | 83.1% | Norway | 79.6% | Switzerland | 88% |
| France | 69% | Russia | 32% | UK | 61.1% |
| Germany | 60% | | | | |

## 2.4 Term

Frequency of re-election and length of term for an outside director has, historically, varied according to board structure, preference and local custom.

In recent years, there has been a clear trend towards maximum recommended terms for outside directors and annual — or at the very least, staggered — re-election by shareholders.

These two developments — of maximum terms and regular re-election — are evidence of an increasing democratisation of the corporate governance process, in response to the twin demands of greater transparency and accountability.

The motivation for fixed and maximum terms is to ensure regular infusions of fresh thinking into the boardroom and to avoid complacency. Indeed, it is the fear that independence is jeopardised after a time that has prompted the widespread adoption of term limits.

This raises the possibility of a more dynamic approach to board composition. The need for certain kinds of expertise among outside directors could mean that longevity is no longer the only measure of a director's success.

A dynamic board should be able to accommodate long-term directors as well as directors who serve only a relatively short term. Certain situations may demand a specific kind of outside contribution where a director is needed for a limited period. An alternative would be for the board to retain an advisor, rather than appoint a director. Such an advisor could attend board meetings by invitation. There should be no harm in a director serving a short term when the reasons for this are understood clearly from the outset. However, too many short-term appointments might become a distraction to the business and could lead to a board in a permanent state of flux.

The appointment and re-election of directors by shareholders is also evolving. Some markets now mandate annual re-election at the AGM for all directors. Originally, it was feared this would lead to instability, that AGMs would become the platform for proxy fights over director appointments and that individuals would allow themselves to be compromised. However, there is no evidence that this has been the case and there is no obvious correlation between the requirement for regular re-election and overall tenure.

For shareholders to fail to re-elect a properly nominated and competent director is very rare indeed — and when it does happen it normally indicates a crisis within the organisation that would have led to instability in any event.

## Average tenure: chairmen and non-executives (years)

| | Tenure | | Tenure | | Tenure |
|---|---|---|---|---|---|
| Belgium | 6.0 | Italy | 5.5 | Spain | 6.4 |
| Denmark | 5.1 | Netherlands | 3.8 | Sweden | 5.8 |
| Finland | 4.9 | Norway | 3.9 | Switzerland | 6.6 |
| France | 6.3 | Russia | 3.4 | UK | 4.9 |
| Germany | 5.7 | | | | |

## TERM LENGTHS AND MAXIMUM TENURE

| | CONVENTIONAL TERM LENGTHS | MAXIMUM TENURE |
|---|---|---|
| **Belgium** | Not more than four years | None specified |
| **Denmark** | Annual re-election recommended but law allows terms of up to four years | No limit but directors lose independence after 12 years |
| **France** | Law allows six years but in practice usually three to four years | No limit but directors lose independence after 12 years |
| **Germany** | Usually five years | Code recommends defining tenure but in practice usually no limit |
| **Italy** | Three years | No limit but directors lose independence after nine years |
| **Netherlands** | Four years | Officially three terms but in practice two terms becoming the norm |
| **Norway** | Two years | No limit |
| **Spain** | Four years by law | No limit but directors lose independence after 12 years |
| **Sweden** | Annual re-election recommended but law allows terms of up to four years | None specified |
| **Switzerland** | Annual re-election | No limit |
| **UK** | Code recommends appointment for a fixed term, de facto three years, subject to annual re-election | Six to nine years is the norm but directors lose independence after nine years; further years possible subject to annual re-election and scrutiny |

## 2.5 Diversity

Just as in society, diversity in the boardroom is a sign of health. Diversity can be expressed in many different ways, but in building an effective board what matters most is diverse thinking. Greater diversity leads to better debates and better decision-making, ultimately leading to better results.

Gender diversity is receiving much public attention and is the subject of both political and regulatory intervention, at national and supranational level. In some countries, ethnic diversity in the boardroom is now emerging as a fresh challenge. The better-led businesses will attempt to act in advance of legislation and indeed many already are doing so.

Regardless of the mechanics used to achieve the result, there is an unstoppable momentum now in favour of greater diversity of thought and experience on boards.

In terms of gender diversity, considerable progress has been made, particularly among outside directors. Progress is much slower among executive directors. To address this will require more than imaginative lists of candidates drawn from wider pools; it will need a re-engineering of corporate HR practices, business priorities and ways of working. Executives with high potential need to be prepared to take on outside board positions. This is a challenge both for the company and for the search professional.

## Non-national directors as a proportion of the board

| | % | | % | | % |
|---|---|---|---|---|---|
| Belgium | 31.8% | Italy | 9.4% | Spain | 15.3% |
| Denmark | 38.9% | Netherlands | 36% | Sweden | 25.2% |
| Finland | 41.0% | Norway | 29% | Switzerland | 60.0% |
| France | 35% | Russia | 43.8% | UK | 33.1% |
| Germany | 23% | | | | |

Just as it is reasonable that a board of directors should reflect the gender of society at large, so they should reflect the ethnic mix. A cursory inspection of the boards of Europe's leading businesses reveals a gulf between board composition and the ethnic makeup of European society or the company's shareholders.

Behind these assertions lies a much bigger challenge — ensuring true diversity in its widest sense.

True diversity is not simply a matter of physical characteristics. It is about allowing flexibility of thought to prevail over groupthink, bringing to any discussion a variety of experiences, perspectives, interests and expertise.

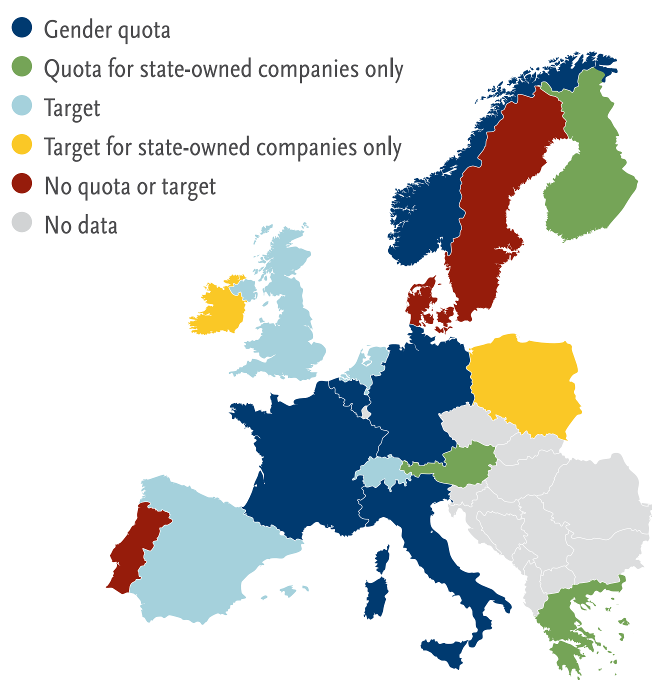
As in any good team there should be a mixture of styles and strengths on boards. Only by balancing perspectives can true debate and decision be achieved. Thus for every director drawn to the status quo, there must be a challenger; for every deeply experienced member there must be at least one who asks the obvious question; the numerate must be balanced by the literate and so on.

The issue of quotas is at the forefront of the current debate. Certainly, the imposition of quotas for representation on grounds of gender or ethnicity, for example, can help achieve numerical objectives more quickly. But this is not the whole story.

## GENDER QUOTAS AND CURRENT REPRESENTATION OF WOMEN ON EUROPEAN BOARDS

Proportion of women on boards

| | |
|---|---|
| Belgium | 27% |
| Denmark | 25.7% |
| Finland | 29.9% |
| France | 38.8% |
| Germany | 26.4% |
| Italy | 26.4% |
| Netherlands | 20% |
| Norway | 44.1% |
| Russia | 7% |
| Spain | 16% |
| Sweden | 36% |
| Switzerland | 20.5% |
| UK | 24.4% |



## GENDER QUOTAS BY COUNTRY

| COUNTRY | QUOTA (TARGET) | REQUIREMENT | DEADLINE |
|---|---|---|---|
| **Austria** | (35%) | Only companies in which state-ownership is over 50% have to comply. However, the 2012 code of corporate governance recommends that companies report on the measures taken to promote women to the management board, supervisory board and top management positions | 2018 |
| **Belgium** | 33% | One-third of board members have to be "of a different sex from the other members" | 2017 |
| **Czech Republic** | | No targets or quotas | |
| **Denmark** | | The 1,100 largest Danish companies are required by law to define their own target of "the under-represented gender". They have to report on progress in their annual reports | In force |
| **Finland** | 50% | Only state-owned companies have to comply with the law that states that men and women must be equally represented on a board of elected representatives unless there are special reasons to the contrary | In force |
| **France** | 40% | All listed companies and non-listed companies with at least 500 workers and with revenues over €50 million. If companies do not comply their board elections may be nullified | 2017 |
| **Germany** | 30% | The quota is binding for non-executive positions. In the case of non-compliance, seats allocated to the "underrepresented gender" are counted as as empty. There is also a target for executive directors, although this is not a binding quota. Companies are expected to set their own goals and report on these goals | In force |
| **Greece** | 33% | The quota applies only to the state-appointed portion of full or partially state-owned company boards | In force |
| **Iceland** | 40% | The quota applies to both private and public companies with more than 50 employees | In force |
| **Ireland** | 40% | Only state-owned companies have to comply | In force |
| **Italy** | 33% | The quota is for quoted and state-owned companies that have at least three members on their board. If companies do not comply they will receive a warning followed by fines | In force |

## GENDER QUOTAS BY COUNTRY

| COUNTRY | QUOTA (TARGET) | REQUIREMENT | DEADLINE |
|---|---|---|---|
| **Netherlands** | (30%) | Large companies should aim to have at least 30% of their board seats held by women. If they do not reach this percentage they have to explain the reasons in their annual report. There are no sanctions | 2019 |
| **Norway** | 40% | Listed and non-listed public limited companies, state, municipal and co-operative companies | 2007 (ongoing) |
| **Poland** | (30%) | The target applies to publicly listed companies in which the state has shares, or to other key companies | In force |
| **Portugal** | | No targets or quotas | |
| **Spain** | 40% | There is a law recommending 40% female representation, but there are no sanctions | In force |
| **Sweden** | | No targets or quotas | |
| **Switzerland** | (30%) | Women should occupy 30% of board seats and 20% of top management positions. | In force |
| **UK** | (33%) | The target applies to the boards of FTSE 350 companies and to the executive committees and their direct reports for the FTSE 100 only. Companies are asked to develop a strategy to achieve this goal and to report on progress. | 2020 |
| **European Union** | (40%) | The target set by the European Commission refers to the under-represented sex among non-executive directors of companies listed on stock exchanges in member states | 2020 |

## 2.6 Diversity at the top of the business

Unfortunately, there is still less diversity among chairmen than there is on the boards they lead. This is an important governance challenge for boards to address.

Most chairmen are still recruited from the ranks of former chief executives or chief financial officers. Among larger companies there is an instinctive reaction to appoint only an individual with prior experience as a chairman. But chairmen have to start somewhere.

Given that there is still a bias towards appointing former CEOs as chairmen, the predominantly non-diverse profile of CEOs finds its reflection in the profile of chairmen.

It is clear that far more needs to be done inside organisations to enhance the opportunities for women and ethnic minorities to progress to senior executive roles. Only then can they hope to become plausible candidates for CEO, for non-executive directorships and, ultimately, for the role of chairman elsewhere.

## 2.7 Commitment

Board members must be able to dedicate enough time to the boards on which they sit, yet the demands on them are becoming more intense and fast-moving.

For an outside director, our experience suggests that 20 to 30 days a year is a reasonable estimate of the time commitment for a public company directorship. Indeed, preparation and reading time, depending on the diligence and efficiency of the director, may add to this. Most chairmen of European companies invest at least twice as much time as other board members.

There may be up to 10 board meetings each year; add to this committee obligations, two or three days away at a strategy meeting and an overseas visit and 20 to 30 days is easily eaten up. And this is before adding additional opportunities to familiarise oneself with the business, attending to any specific tasks and various continuing education obligations.

Inevitably this has consequences for who can plausibly be a candidate for a directorship and who is able to properly discharge the responsibilities.

A sitting executive may find it a challenge to carve out 20 or 30 days from the calendar — even allowing for doing much of the preparatory work at weekends.

Fortunately, most employers see real advantage in permitting their executives to serve on another board. The merits are obvious — it broadens the executive's experience and understanding, and provides exposure to other ways of doing things. Moreover, the cross-fertilisation this encourages is likely to promote best practice.

However, it is unlikely that a sitting executive could easily cope with more than one, or exceptionally two, outside appointments. Most companies seek at least one or two sitting executives on their boards because their contribution is a reflection of current business practice. CEOs are particularly in demand and can afford to be highly selective.

The balance of directors could be taken from the recently retired, for their recent experience, or from the actively "plural", for their energy and breadth of vision — always leaving room for the "elder statesman" who brings, hopefully, additional perspective and wisdom.

## 2.8 Number of directorships

As to the maximum number of directorships that a "plural" outside director can contemplate, in previous years one might have said as many as five. However, with today's level of expectation and commitment, more than three or four listed company directorships is potentially too many. The burden is exacerbated if one or more of the companies fall into crisis. Many directors also have private company, pro bono or not-for-profit positions and the demands of these too can mount up. Nomination committees rarely take account of these commitments, although they should.

Calendar compression is a serious issue. In many markets, corporate year-ends are concentrated around a particular date, for example 31 December. This puts diary pressure on plural directors who have to attend AGMs and accounts approval meetings for example, leaving less time for more reflective contributions.

Board composition can be driven as much by practical considerations as by business needs. For example, it may well be determined by the location and frequency of meetings. International businesses often require regional expertise on the board. However, the practical difficulties of attending a board meeting in Europe for a director based in, say, Hong Kong should not be overlooked. Some organisations have appointed regional advisory boards that avoid the logistical difficulty of having directors flying across continents to board meetings.

## 2.9 Skills and attributes

Much is demanded of outside directors. For a start, they need to understand the business model and the factors critical to its success.

Traditionally, chairmen preferred to choose people with prior board experience or those already sitting as executive directors. But as boards seek more diversity, the net is being cast more widely. People from advisory backgrounds, the public sector and academia are joining boards, bringing with them very different sets of abilities. In addition, boards are looking closely at other companies' executives immediately below board level, for example those on the executive team.

The ranks of first-time non-executive directors are swelling as boards seek to correct gender and ethnic imbalance and bring in expertise with specific current skills such as digital, social media or consumer behaviour. Boards are also hiring people with experience of a specific geography. Many of these will rightly be younger appointments.

A summary of the attributes of the ideal outside director might read as follows:

» Commercially aware, financially literate with a good appreciation of risk
» Internationally minded and multilingual
» Interested in the business, committed and well prepared and used to dealing with complexity
» Objective and independently minded, prepared both to challenge and support management yet still a team player
» A relationship-builder and an ambassador
» Intellectually flexible with a sharp mind, able to think laterally and beyond their area of expertise
» Having a particular experience of relevance to the board
» Clear understanding of prevailing governance practice and fiduciary duties
» Fair-minded, having absolute integrity and wisdom and above all courage and common sense
» Articulate and persuasive whilst being a good listener and a good communicator
» And — perhaps most importantly — low in ego yet high in self-confidence.

These are general skills and attributes. Increasingly, boards seek non-executive directors to meet more specific criteria: skill sets, regional experience or other areas of knowledge.

Indeed, this specific “extra” is often the defining feature of what a board looks for in a new non-executive. A board may have identified a need in the context of geographical operation, or knowledge of a specific sector such as financial services, or in an area of risk such as cyber and data security or regulation.

In all of these examples, we believe that the non-executive should not be expected to substitute for a missing executive skill — that must be solved at the executive level. Rather, the expert non-executive director can act as both an informed commentator and interpreter for the rest of the board.

So, an outside director with a relevant skill set can be helpful in translating a particular issue into language understood by a predominantly non-expert board.

However, there are dangers in having a technical "translator" on the board, especially if the dialogue between the director and the relevant company executive excludes other directors. The presence of an expert does not mean that the other outside directors should not seek to master a particular issue: they are not being given permission to switch off from a discussion.

The challenge is that when you bring an individual with deep skills on to the board, they must always be capable of contributing beyond their area of specialism. Particular expertise is optional — but the other attributes of a successful director are mandatory.

## Maximum number of mandates

In some jurisdictions the law and corporate governance codes set different limits for the number of mandates that directors may have. The maximum number varies greatly across the region.

Directors of financial services companies are subject to the limits indicated in the EU's Capital Requirements Directive IV (CRD IV), which states that unless representing a member state, members of the management body of a "significant" financial institution must comply with one of the following: an individual may either have one executive directorship plus two non-executive directorships or four non-executive directorships. Companies within the same group count as separate entities, but not-for-profit or charitable organisations are not included in the restriction.

BELGIUM
Five listed companies but no further specification.

DENMARK
No rule, but the code recommends not taking on more than "a few" non-executive directorships or one chairmanship and one non-executive directorship in companies outside the group.

FRANCE
By law, a person may sit on no more than five boards of companies headquartered in France. The corporate governance code limits executives to two outside boards and portfolio directors to five boards, irrespective of whether they are French or foreign.

GERMANY
The law allows a maximum of 10 mandates, with chairmanship counting double. The code sets a maximum of three mandates for reasons of workload.

ITALY
No limit is set for executives. For portfolio directors, each company must set a limit.

#### NETHERLANDS

A points system operates whereby directors who are Dutch nationals are allowed mandates totalling five points. They may be non-executive director of up to five Dutch companies or organisations, with a chairmanship counting double. Active executives are limited to two non-executive directorships. This applies to companies fulfilling two of the following criteria: at least €35 million revenues; at least 250 employees; €17.5 million assets.

Mandates at non-Dutch companies are not counted in this scheme and neither are cooperatives and some NFP organisations.

#### NORWAY

No rules, but in practice, two is generally seen as the maximum for executives and four for a portfolio director.

#### SPAIN

No limit is prescribed. Each company sets its own requirements and more than half do have a limit — four is becoming the norm, in line with financial services.

#### SWEDEN

None specified.

#### SWITZERLAND

For listed companies, the code recommends a maximum of five per director, with no distinction between executives and portfolio directors. There are no limits for non-listed companies.

#### UK

The code recommends that a serving executive should have no more than one FTSE 100 mandate and no chairmanships. In practice, it has become the norm to apply this recommendation to all outside directorships.

Chairmen are expected to chair no more than one FTSE 100 company. There is no prescribed or recommended limit for portfolio directors, but in practice a maximum of four seems appropriate.

## 2.10 Fit

It is essential that outside directors bring to the board an awareness of the context in which the company operates.

Outside directors are normally appointed for their specific sector, geographic, financial, commercial, marketing or other expertise relevant to the company's business or perceived needs.

But knowledge and experience are not enough unless they are complemented by a soft skill set. Emotional intelligence is as important in being a successful director as IQ. There is no point in holding an opinion if you can't put it across constructively and at the right moment.

Collegiality must also join the list of what makes a good fit — but not at the expense of objectivity or courage.

For a potential director to be a good fit the board must see belief in and emotional commitment to the purpose of the business. Most importantly, there should be clear excitement about the challenge.

Keep in mind that a unanimous decision is reached via constructive debate and sometimes by a degree of measured disagreement. So board deliberations must be characterised by trust, openness and mutual respect. This is not to say that sociability is a prime requirement, but boards of directors are both business and social constructs. The most effective outside director is one who is listened to and gaining a hearing is a social skill. Regardless of the skill set, the question for the company is ultimately: will the candidate fit?

## 2.11 Board culture

As the steward of corporate behaviour, the board's first obligation is to ensure that its own culture is beyond reproach.

A board's personality depends on a number of factors, for example the nationality, history, cultural roots and ownership structure of the company. The board's size, the profile of the directors and the degree of formality in its dealings also play a part in building corporate culture and reputation.

The chairman has a significant role in shaping the style and culture of the board in terms of how relationships are conducted, the quality of teamwork, transparency, communication and freedom of expression among directors, and interaction with the executive team. Every board should therefore consider these matters carefully, for they serve to promote the best interests of the company.

While board behaviours have less influence on culture than those of the CEO and management team, boards do set a tone that in turn has an impact on the company's culture. Boards should be aware of what that tone is and how they contribute to it by their own actions. They can ask themselves:

» How do our boardroom behaviours advance the right tone at the top?
» Are we sufficiently inquisitive, collaborative, disciplined and decisive?

Remember, we are talking about the spirit and dynamic of the board. This is not necessarily the same thing as the culture of the company. The board is a principal custodian of company culture, but it has a spirit of its own and to some degree this will inform the company's own culture.

# 3. Induction and education

## EXECUTIVE SUMMARY

» All boards should operate a tailored induction programme for all directors, whether first-timers or not.

» Continuing education for directors is essential to ensure they are aware of business, legal and operational changes and the impact on their responsibilities.

» Directors should be given every opportunity to see the operations at first hand to support their understanding of the business.

» Tailored programmes such as Spencer Stuart's Directors' Forum should be a part of every outside director's commitment.

## 3.1 Board induction

Chairmen and boards have a responsibility to ensure that new directors are given proper support in learning their role so that they can get up to speed as quickly as possible.

An induction programme should be mandatory for all directors, regardless of experience.

The induction is usually overseen by the company secretary. New directors should ask for the process to be tailored to them, particularly if they feel they want to explore certain areas of the business in greater depth.

A full programme should involve:

- Presentations from management on the business model, profitability and performance
- A review of the previous 12 months' board papers/minutes to understand current issues
- Meetings with key executives/functions such as finance, marketing, IT, HR, etc.
- Site visits to understand how the business works and to meet people on the ground
- Meetings with advisors, for example, bankers, brokers, accountants or others
- Explanation of regulatory and governance issues
- Attendance at an investor day.

**New directors (proportion of the board appointed in a 12-month period)**

| | % | | % | | % |
|---|---|---|---|---|---|
| Belgium | 12.5% | Italy | 17% | Spain | 14.9% |
| Denmark | 10.9% | Netherlands | 13% | Sweden | 19.1% |
| Finland | 14.4% | Norway | 17.2% | Switzerland | 10.5% |
| France | 14% | Russia | 17.7% | UK | 14.9% |
| Germany | 16.9% | | | | |

## 3.2 Mentoring

The practice of mentoring existing and aspiring directors is increasing. The mentoring is often done by an existing director or sometimes by an external professional. There is an opportunity for mentoring new directors. For instance, an existing director could take charge of the induction of the new colleague and be responsible for making them comfortable in the role and maximising their potential — at least for the first six months.

## 3.3 Role assignments

Any director's arrival on a board will be made easier if they are able to make an immediate contribution.

For instance, the chairman should not wait to make a new director a member of at least one board committee; it is appropriate that all outside directors should serve on at least one committee.

Sometimes unitary boards assign particular spheres of interest to an outside director, relevant to their experience. This can take the form of assigning to them a part of the business operations or function as an area of first responsibility. Such assignments can be valuable and, again, should not be delayed.

## 3.4 Continuing education

Boards should seek continuously to develop the knowledge and competency of their directors. Business complexity is increasing, as well as governance, accounting, legal and regulatory changes that require regular training updates. In the same way that directors expect management to be at the cutting edge of their industry, management expects directors to keep themselves informed about their role, the sector and the company.

This obligation is the subject of constant review and will normally be reported on annually to shareholders and others.

Well-resourced companies can contemplate undertaking the task of continuing education themselves, but it is a broad field of study.

There is no shortage of organisations offering to update and educate directors. For first-time non-executives we recommend participation in one of the many new director training programmes available. Such events offer the opportunity to become more familiar with boardroom debates and governance issues. Accounting and law firms also hold regular seminars updating directors on the latest developments in remuneration, audit, risk and governance generally.

## Advice to aspiring outside directors

Taken from _Becoming a non-executive director_, published by Spencer Stuart

*What follows may be helpful for experienced directors passing on advice to executives who have not yet served on an outside board.*

Your first directorship is also the hardest to get and will take the longest; but others will follow more quickly once you are a non-executive director and have experience.

A serving executive is generally only allowed one, or occasionally two, non-executive roles, so it is vital to choose the right company. What you are seeking may be neither appropriate nor what you need at this point. Your options may be limited by your own board or by local corporate governance rules. You have to be realistic and pragmatic. Organisation size and status aren't everything; you should consider the option(s) most suitable to your background and experience.

Similarly, if you are about to retire from executive life the first non-executive directorship you choose is critical — it will signal the scale and type of company you are interested in and position you for future opportunities.

Identify sectors which you know or are contiguous with the day job. Look for companies which need or match your particular expertise, but which are sufficiently different not to pose a commercial conflict; companies you can learn from, as well as contribute to.

Bear in mind the following:

» Sitting on a board for several years feels like a long time if you're not enjoying it.

» Mistakes will be on your CV forever.

» Do not underestimate the time commitment. It is not just a question of preparing thoroughly for meetings (reading the board papers is essential), but making time for site visits and meetings with management.

» Aim high, but be realistic.

» Think through any potential conflicts of interest.

*continued >*

- Don't be hasty; the right opportunity is unlikely to become available immediately. Don't be surprised if you go to many interviews before you find a board that is willing to hire you and that is a good fit. This is normal, so be patient.
- Be prepared for rejection. Try to find out why you were rejected and learn from it.
- Contiguity is inevitable and to be welcomed. This is not a time for reinvention. You will be hired for who you are and what you have done, so stay close to what you know.

Spencer Stuart Directors' Forum is the leading international programme designed to equip new and aspiring directors for life inside the boardroom (see Appendix B). This programme is augmented by membership of an alumni group — a ready-made network of fellow directors.

## 3.5 Outside directorships as a career

All the above are responses to the growing professionalism required of outside directors. No longer hired for their experience or business relevance alone, outside directors are expected to have a working knowledge of relevant governance requirements and of the regulatory environment in which they and their colleagues operate.

This in turn is a response to the appearance of the "plural" outside director — a person who might have secured their first appointment on the basis of their executive experience, but who is subsequently appointed for their non-executive and independent qualities.

The “plural careerist” has undoubtedly professionalised the role of the outside director. As with other professions this should bring in its wake specialist training and the elevation of the company’s interest and those of stakeholders over the interests of the director.

# 4. Board leadership

## EXECUTIVE SUMMARY

- The chairman should set the tone for the board by encouraging open and candid discussion involving all board members.
- The roles of chairman and CEO are usually better separated to avoid an undue concentration of power.
- The chairman-CEO relationship is key and the responsibilities should be complementary not overlapping.
- The CEO should not become chairman except in exceptional circumstances.
- Most unitary boards benefit from a clearly defined role for the senior independent director and deputy chairman.

## 4.1 The chairman

The leadership of the board is the sole responsibility of the chairman. Today's effective chairman brings time, business experience, personality and maturity to the role.

The chairman sets the tone and regulates the conduct of the board. Consequently, the manner and quality of its deliberations to a large extent reflect the chairman's way of doing things. It follows that the chairman plays a leading role in the composition of the board.

The role and influence of the chairman has grown significantly in recent years and, as a consequence, today's chairmen have more diverse profiles and backgrounds than in the past.

The required style of board leadership has also changed. It used to be that chairmen either provided robust leadership from the front or existed merely as ceremonial figures. Now, chairmen are required to coordinate a board of strong outside directors and, when things go wrong, be ready to slip into executive mode. Greater versatility and a broader range are imperative.

So the chairman has a significant influence on the culture and tone of the board. By setting the agenda and ensuring that the board is addressing the right topics at the appropriate level, the chairman promotes active participation of all directors.

The chairman's influence and judgement is vitally important because it dictates the nature and quality of debate. It is the chairman's responsibility to create an atmosphere in which topics are open for discussion and board members can disagree with each other if necessary. They should be able to express their views openly and candidly without fear of being considered disloyal. Effective debate and full disclosure at meetings make it less likely that divisive discussions will take place outside the boardroom.

When members spend time with each other outside board meetings it helps build trust and understanding within the board.

Some investment by the chairman in the social side is therefore beneficial to board relationships.

The chairman should encourage strong relationships and respectful interaction between executives and non-executives. The key principle here is trust: management will share their concerns with the board if they perceive a cooperative and supportive atmosphere.

The chairman should determine how and when non-executives communicate with executives outside board meetings. Relationships between the board and management can be strengthened in a number of ways, for example by inviting executives to present to the board, having directors make site visits and by mentoring.

All of the above comments apply equally to one- and two-tier boards. But in the two-tier system, the CEO and chairman have the additional responsibility of ensuring that the supervisory and management boards communicate and interact productively. In some jurisdictions, directors' communication with shareholders is strictly regulated. For example, in Germany, only the CEO can discuss operational matters with shareholders. The chairman is only entitled to speak to shareholders on issues relating to the board.

There are many effective ways to lead a board of directors — perhaps as many as there are personalities in the chair.

It may be the diplomat who facilitates or the intellectual who listens; the conservative who cautions or the radical who inspires.

Whatever style the chairman might adopt, the principle aim is always to draw the best from the board, to support and encourage the executives and to ensure that the board as a whole is significantly greater than the sum of its parts.

## The evolving role of the chairman

As their responsibilities have grown, most chairmen in a unitary board system would see themselves as the chairman of the company, rather than of the board only.

But whatever the system, whilst the management of the board and the smooth running of its deliberations are obviously part of the chairman's role, they no longer define it.

Increasingly, in both the unitary and two-tier board systems, enhanced public scrutiny of corporate life has promoted some chairmen to the role of one of the company's public representatives. Depending on the personality and profile of the CEO, this role can be significant.

In some two-tier systems, the role of the chairman is more constrained as a result of custom, practice and even regulation; however, in the absence of a formal constraint, chairmen are increasingly being drawn into the public debate.

Thus, the chairman may become another resource for the company in all its public dealings. As a result of the chairman's raised profile there is a need for more rounded and experienced candidates.

When selecting a chairman, his or her style of leadership should be clearly understood. Going against conventional wisdom can be an effective strategy and is sometimes necessary, but the better default position for a chairman is to have a more low-key style that brings out the best in other directors.

## 4.2 The chairman as CEO

Thirty years ago, the orthodoxy in unitary boards was for companies to be led by an executive chairman whose power was effectively unrestrained other than by the collective of the board. In response to a series of high-profile abuses of corporate power, a number of countries determined that a better governance model would be to separate the leadership of the company into two roles — those of the chief executive and non-executive chairman.

Today, there is a growing belief around the world that the roles of chairmen and CEO are better separated. An undue concentration of power in one pair of hands heightens risk.

Board members should always feel free to challenge the CEO about the decision-making process in a robust and constructive manner. When the CEO is also the chairman, directors may feel inhibited. Since the balance of information is heavily weighted in favour of the combined CEO/chairman, the directors may feel at a practical disadvantage. For these reasons, we believe that in the unitary context splitting the roles is generally in the company's best interests.

Some circumstances may justify the roles being combined, in which case the board has an obligation to explain why doing so is in the interests of both the

## To combine or separate the roles of chairman and CEO?

### BELGIUM
The governance code recommends that the roles should be separated, which is almost always the case.

### DENMARK
Two-tier system: the roles are always separated.

### FRANCE
There is a choice of three formulas:

1. Chairman/CEO
2. Chairman and CEO are separated
3. Two-tier system with supervisory board and management board

66% of companies choose option 1.

### GERMANY
Two-tier system: the roles are always separated.

### ITALY
Separating the roles is common. However, there are many executive chairmen. Structure depends largely on the company ownership (family; government, etc.).

### NETHERLANDS
Two-tier system: the roles are normally separated. There are very few exceptions in family-controlled companies.

### NORWAY
Two-tier system: the roles are always separated.

### SPAIN
57% of chairmen are also CEO. But even where there is a formal separation, often the chairman is de facto CEO and the CEO is de facto COO. Out of the remaining 43% at least half are purely cosmetic. Many founders remain as chairman and therefore de facto CEO.

### SWITZERLAND
There has been a big change in the last 10 to 12 years towards splitting the roles. 95% have separated.

### UK
The roles are almost always split. The code stipulates that there should be a clear delineation, but there are one or two examples where there is an executive chairman, with or without a CEO as well.

shareholders and the company. It should also be made clear to shareholders how long this situation might prevail and the circumstances in which it might end.

Naturally, the question of whether the roles of chairman and CEO should be combined in one person only arises in the context of the unitary board.

## 4.3 The "deputy" chairman

The position of deputy chairman is a feature of board governance regardless of whether the roles of chairman and CEO are separated or combined. In some jurisdictions the equivalent position is known as the senior independent director or the lead director. The role is designed to provide the following:

» to offer a sounding board for the chairman
» to serve as an intermediary for other directors when necessary
» to provide a point of contact for shareholders as an alternative to the chairman
» to lead the chairman's performance evaluation on behalf of the board
» to conduct the chairman succession process
» to chair meetings of the non-executive directors once a year, or more frequently when the chairman is also the CEO
» to manage the board in the chairman's absence.

Under normal circumstances, the role of the deputy chairman or senior independent director is limited to occasional contact with shareholders, and to leading the annual evaluation of the chairman's performance. The role comes into its own in times of crisis or when a change of chairman is being considered.

In companies where the chairman is also the CEO, the deputy chairman or senior independent director has the vital role of acting as a counterweight to the chairman's concentrated power. This requires an individual with both presence and authority.

## The role of the deputy chairman or equivalent across Europe

BELGIUM
The code only refers to the role of the chairman

DENMARK
The role of deputy chairman is not compulsory and the senior independent director is not a current concept

FRANCE
The role of senior independent director is defined in the corporate governance code, but specific role specification is left to individual companies

GERMANY
There is at least one deputy chairman

ITALY
The role of vice chairman is legally required

NETHERLANDS
Not required, but many companies have a vice chairman performing this role

NORWAY
Not compulsory, but usual in larger companies

SPAIN
Where the chairman is also the CEO there will be a lead director

SWITZERLAND
Not legally defined and not compulsory, but an increasing number of companies appoint a senior independent director, usually the same person who holds the vice chairmanship

UK
The corporate governance code recommends that one of the independent directors be appointed senior independent director and there is near-total compliance.

## 4.4 The relationship between the chairman and the CEO

The relationship between the chairman and the CEO is the most important one on the board. Together, they represent the public face of the company and, to a great extent, take joint responsibility for its success or failure.

Often, the most effective combination is based on complementary strengths, where one compensates for and reinforces the other. Chairmen and CEOs of a similar character can nevertheless make formidable pairings, providing they reach a clear understanding of each other's roles. That said, their relationship is always coloured by one simple fact — it is the chairman's ultimate duty to change the CEO if things do not work out.

A good chairman is an ever-present resource to the CEO and will have the courage to guide, challenge and support him or her. But it is important that the chairman does not become a shadow CEO. Nothing will guarantee a break-down in relations like a chairman seeking to perform the CEO's duties.

If there is a fractured relationship between the chairman and the CEO, or if they are not aligned on the company's objectives, long-term commercial success will be impossible to achieve.

There is a preference amongst some boards to promote former CEOs to the role of chairman in the same company. This raises a number of interpersonal issues and requires specific explanation to the shareholders.

Given that the relationship between the chairman and the CEO is the most significant in the business, regardless of board structure, then having a chairman who sits in judgement on their own successor creates a difficult dynamic.

If the CEO is to become chairman, boards should at least consider a grace period — but, grace period or not, it remains a poor idea, rarely justified.

# 5. Succession planning

## EXECUTIVE SUMMARY

- The company's strategy should inform the range of skills most needed for the board.
- There should be a continual process of reviewing and identifying board needs and an early start should be made on each specific recruitment.
- Boards should conduct an inventory of the skills, contributions and cognition of current board members to identify any gaps.
- The chairman's succession should be planned carefully, coordinated with anticipated board changes and handled by the senior director, deputy chairman or similar.
- The best boards should contain at least one or two directors who are plausible chairmanship candidates.
- Independent advice should always be taken to ensure objectivity and provide a justification for each decision.
- For CEO succession, an early start is essential and knowledge of internal and external candidates should be a constant preoccupation for the board.
- A pipeline of internal candidates should be identified through regular succession reviews, in conjunction with an external consultant.
- Priority should be given to a rigorous assessment of character and capabilities, achievement to date and potential in the role, as well as cultural fit with the organisation.
- A multifaceted evaluation like this must be conducted by an outside consultant with access to the appropriate expertise, data and intellectual property.

## 5.1 Whole board succession

Boards are increasingly taking responsibility for their own succession needs. Many are intent on observing best practice for reviewing director performance and recruiting the next generation.

Succession starts with strategy. A company's direction should inform the range of skills most needed around the boardroom table. An ideal mix of expertise will ensure that a board can fulfil its responsibility to advise, supervise and challenge management.

Board succession is most often the responsibility of the nomination (or nomination and governance) committee but the appointments themselves are made by the whole board, generally on the committee's recommendation. The committee responsible should keep the full board informed about its deliberations rather than introduce a shortlist of preferred candidates once selected. The best processes ultimately involve all board members. That should certainly be the aim.

It is worth noting that in some jurisdictions the appointment of a director is not valid until approved by shareholders. In the UK the board appoints a new director with immediate effect, and this is ratified at the next shareholder meeting.

Directors should not assume that an ideal candidate will be easily found or, once found, readily available. There is competition for talent among potential non-executive directors just as there is for top executives. Boards should therefore consider casting a wide net and planning their recruitment well in advance.

The need for early planning of board succession is greater today in the light of public scrutiny, pressure from rating agencies, governance watchdogs, regulators and the demand for additional skill sets to support changes in company strategies. All boards, from major corporations to not-for-profit organisations, are increasingly in the spotlight and need to demonstrate their willingness to evolve.

Consequently, succession planning should not be an episodic event or exercise; it should be seen as a continuing process.

This applies equally to the critical positions of chairman and CEO. Here, the process of succession in the longer term should begin upon appointment. Indeed, thinking about this issue should be all-encompassing, embrace all board positions and should be a standing agenda item for the nomination committee.

Gradual reinvigoration should be the aim, with retirements and appointments ordered to satisfy the need for both continuity and fresh thinking. Each board seat should be occupied by a skilled director who knows his or her role, has received a thorough induction and continues to be offered appropriate development opportunities.

All this is best achieved if the board is consistently advised by an external consultant, creating a partnership with the business that has the single ambition of smooth succession, whenever it is required.

Well-informed board succession planning ensures a strong, relevant board.
A transparent process helps to create a respectful boardroom culture. High-performing boards use a variety of tools to facilitate succession planning, and we shall now look at some of them.

## 5.2 Guiding principles for board succession

Effective board succession depends on the following:

» A continuing process of reviewing and identifying needs

» An early start on each specific recruitment

» Definition of the skills, experience and diversity necessary to support the strategy and populate committees

» Inventory of the skills, contributions and diversity of current board members to identify any gaps

» Annual board review process including feedback for individual directors

» The board's policy on tenure and exiting members: performance review, term limits or mandatory retirement

» Committees structured to include the requisite skills and experience.

Used consistently, these tools should produce a clear picture of the gap between the board today and what it needs to be in the future. The nomination committee should formulate a plan for how to bridge that gap.

The makeup of the board and the planning of changes should be sequenced to avoid clusters of departures. Given the increasingly common practice of mandating maximum terms, wholesale change can occur at a bad time for the business. Staggered appointments are therefore important; without them the board may undergo an unplanned culture shift.

Boards that are most effective at succession planning ask the chairman or senior independent director to have candid conversations with directors at the outset about how long they plan to serve. This shared understanding between the board and each director is often the missing piece in the jigsaw of board succession planning.

It is difficult to ask long-serving directors to make room for directors with new or different skills. But careful long-term succession planning, overseen by the chairman and the relevant committee, helps to make these transitions smooth and dignified.

## 5.3 Factors to consider in board succession

In recent years, several factors have increased the complexity of board succession planning:

» The need for remuneration committees to be experienced in developing complex remuneration plans and to conduct their work with sensitivity to outside opinion
» An increasing demand for specific competencies and risk management experience among audit committee members
» The need for directors to chair these committees
» The need for directors who understand digital and social media tools
» The need for diversity (cognitive, gender, age, ethnicity, etc.)
» A global vision
» Foreign market expertise
» The need to satisfy regulators

- Rising attention to term limits
- The increased risk of legal liability
- Greater scrutiny from investors and the media.

These requirements, some practical and some professional, mean that a comprehensive search process has to start early, as we have already noted. It should also be both wider and deeper, to ensure that the best candidates are identified and reviewed. Calling upon external professional advice is now standard practice to satisfy stakeholders that this is the case.

## 5.4 Chairman succession

This subject requires careful thought and, again, long-term planning. The chairman should not manage his or her own succession process. Rather, chairman succession should be handled by the senior independent director, deputy chairman or equivalent. Difficulties can arise where the chairman is also the CEO and where board members may not feel confident, either individually or collectively, in raising such a sensitive topic.

Since the candidate pool for chairmen is perceived as small and demand is high, it is imperative that the board has a plan for chairman succession and starts the process early.

Our observation is that boards almost always leave it too late — defying the basic principle of succession planning that it should be planned. It therefore helps for everyone to have a common understanding of the likely term for the chairman.

Each board should make a point of discussing chairman succession openly and without any implied criticism. There should be a clear line of sight at least 12 to 18 months ahead.

The best succession process begins on appointment, as we have emphasised above. The best chairmen are aware of this too. Succession of the chairman should ideally be coordinated to avoid clashing with the end of the CEO’s tenure. It is important to avoid both being replaced at the same time, especially as one of the chairman’s principal duties is to manage the CEO’s position.

It is not uncommon for a candidate for the chairmanship to emerge from among the existing outside directors. The process should be flexible enough to accommodate this and for appropriate arrangements to be put in place to avoid conflict and ensure a level playing field.

Sometimes a chairman candidate is recruited to the board with a view to becoming the chairman within 12 months — a strategy that can ensure an orderly and timely process.

It is sensible to recruit at least one non-executive, well ahead of time, who has the capacity to become the chairman in the future.

Such a plan should complement the succession plan for the CEO — the two plans should be sequential not simultaneous.

## The chairman succession process

The process for chairman succession is typically led by the deputy chairman or senior independent director (SID). There can be good reasons why the SID does not lead the process, for example if he or she wishes to be considered as a candidate. In this case, the process is led by another senior board member.

The director leading the succession process may form a chairman succession committee (CSC) to run the process. In some cases, the composition of the CSC is identical to that of the nomination committee and in others it is different but typically it includes members from the nomination committee.

The committee members should not include directors who wish to be considered as a candidate for the role of chairman. The current chairman should not be a member of the CSC.

The CSC should appoint a search firm to advise on the chairman succession process. As a first step, the CSC and the search firm should agree a timetable with clear milestones and deliverables.

The CSC, with the support of the search firm, should then draw up a specification for the role of chairman. The specification should outline the ideal business experience and track record given the company's likely agenda over the next few years; it should also set the priorities for criteria such as nationality and domicile and detail the expected time commitment and key responsibilities for the role. Ideally, all board members should be consulted for their views on what the specification might include.

Once the CSC has approved the specification, the search firm begins the research to identify qualified candidates. All directors should be invited to submit any candidate suggestions they may have and these should be included for the CSC to consider, alongside those candidates identified by the search firm.

Shortlisted candidates should be interviewed by the chairman of the CSC and at least two, but ideally all, members of the CSC. When the committee has decided upon its preferred candidate (or final two candidates), he or she should meet the CEO. At the end of the process, the finalist candidate should meet the current chairman and those board members who are not CSC members; this is often done in a more social setting, for example at a board dinner.

It is good practice for the chairman of the CSC to report regularly to the full board on the progress of the succession process. The CSC may also choose to share candidate names with the full board.

The deputy chairman or SID should discuss with the chairman the timing of the handover to the chairman's successor.

## 5.5 CEO succession

CEO succession is in many ways the most important issue for the board. As with board and chairman succession planning, it is a continuous process, best served by taking external advice.

The best time to start the process is early in the CEO's tenure. Leaving it later can lead to misunderstandings — it is up to the chairman to initiate that discussion.

The company approach has to be clear and agreed before embarking on a succession planning process. Effective, long-term succession planning should encompass these six elements:

» The right, air-tight process
» Well-defined requirements for the future leader
» Thoughtful assessment of internal candidates and tailored development plans
» Accurate comparisons to external talent benchmarks
» Powerful decision support at crucial times
» Successful transition plans and support.

The board has to be certain that there is a pipeline of high-quality executives rising through the ranks and capable of joining the senior executive team. The board, and especially either its chairman or that of the nomination committee, should be capable of forming an assessment of the next generation of top executives.

## CEO succession — avoiding pitfalls

CEO succession represents a critical turning point for companies when tremendous value can be created or destroyed. Furthermore, succession planning is complicated, requiring the board to manage through the complexity and risk of the decision and the different ways in which events may unfold over time. Succession planning also can be a highly personal and charged topic, particularly for the CEO. Part of the board's role is to defuse these issues and minimise the emotion of the process.

A properly handled long-term process will increase the likelihood that the company will produce a strong internal candidate, while ensuring that disappointed internal candidates are treated with courtesy and tact.

We have identified three critical steps to avoid pitfalls.

### START EARLY AND REVIEW THE PLAN REGULARLY

In the best processes, objective, third-party assessments of internal talent occur early enough to provide candidates time to develop and the board time to build a fuller, more nuanced view of internal players. The board should review the plan and candidates' progress at least once annually.

### BUILD AND MAINTAIN TRUST IN THE PROCESS

Once they have been through it, directors often remark on the power of the succession process to align the board around the strategic direction of the business, the capabilities needed in the next CEO and in the ultimate CEO successor. This only happens when the board oversees an effective, transparent process, ensures that the stakeholders understand the process and maintains an open line of communication with internal candidates.

### REMAIN VIGILANT EVEN AFTER A DECISION IS MADE

The board should stay involved in the CEO transition to ensure the incoming CEO establishes a clear plan for the early days of the transition and that it is executed in a disciplined manner. The board also should make sure that the outgoing CEO provides the necessary support to the new CEO without seeming to interfere.

Any selection process will inevitably involve a series of early choices. For example, the board may prefer a proven CEO with a strong profile among investors. Specific industry expertise might be more highly valued than a good track record in more than one industry. Boards should always be prepared to revisit these preferences as the merits of individual candidates become clear.

Responsibilities should be clearly established by defining the different roles of the chairman, the full board and its committees. It is vital for board members to maintain confidentiality when CEO succession is discussed, particularly when internal candidates are being considered.

The early identification of an "anointed successor" should be avoided. The risk is that this takes away the board's ability to respond to subsequent events, leaving it with too few options.

If the CEO departs unexpectedly, the board has to be prepared to ensure management continuity. The board and the CEO should together establish a strategy in advance and define the procedures that will take effect if an emergency occurs. The chairman of the board or of the committee responsible should know the potential candidates who are willing to take on management responsibility in an emergency or which board member may be able to step in.

Assembling a list of candidates and selecting the right one is and always should be a bespoke exercise. Context is everything. It is not the case that outsiders are per se preferable to insiders or vice versa – it will always depend upon the candidates' abilities and the company's needs at the time. It is the board's job to look beyond an individual candidate's track record to see that their true potential addresses the corporate opportunity.

## 5.6 Succession of combined chairman/CEO

In countries where separating the roles is standard, the appointment of a combined chairman/CEO is usually a response to specific circumstances and seen as transitional. Examples might include a company founder or a long-tenured and particularly successful CEO. In these cases, a chairman/CEO successor will generally be found from within and not necessarily involve a third-party search.

In jurisdictions where the combined chairman/CEO leadership structure is the norm, the process should be similar to the search for a chairman described above, i.e. led by a senior board member, not involving the current chairman/CEO, and carried out under the guidance of an external advisor.

In such a combination, the principal need is for a compelling candidate for the CEO role who is able to perform the role of chairman, and not vice versa.

## 5.7 Succession below CEO level

The board must view senior executive succession as a medium- to long-term process, avoiding ad hoc appointments that bring with them the risk of failure. The board should take the opportunity to oversee the succession of senior-level executives in the internal pipeline. The following measures need to be in place and kept under permanent review:

» Exposure to the senior team and the level immediately below is essential. This can be both formal and informal — through the medium of boardroom presentations and attendance, or through business and social events, preferably both

» Regular opportunities for getting to know key managers with potential, including their participation in the annual strategy meeting

» Regular reports from the executive team on high-potential employees and the provision of development support

» Agreement between the board and the management team on the criteria for appraising the next generation of management

» Either a committee or the full board to monitor the systems for developing and promoting future senior managers.

Current best practice is as follows:

- » A professionally assisted review of the candidate pool for senior positions. This in turn involves an analysis of the candidates' strengths, weaknesses and potential, enabling boards to come to decisions on long-term succession planning — in the interests of both the company and the executive themselves
- » Professional, confidential benchmarking of possible internal candidates against external executives, especially in relation to CEO succession, should form part of this scrutiny
- » Top-tier effectiveness requires a careful review of the structure and membership of the executive team or management board. The ability to work collectively and through others is vital and can only be properly evaluated by a third party using robust assessment tools.

Regardless of whether the board is unitary or supervisory, the principal issue is that the senior executive pipeline should be under constant and dynamic review.

## 5.8 Executive assessment

In all executive appointments, in particular the CEO, it is best practice to conduct a rigorous assessment of the individual character and capability of finalist candidates.

This assessment should cover, as a minimum, a comprehensive review of achievements to date, rigorous evaluation of the candidates' potential in the specific role, their character, capabilities, leadership style and cultural fit with the organisation.

An integrated, multi-method approach must be carried out by an experienced assessment expert, properly resourced and backed by appropriate intellectual property and benchmarking data.

The objective should be to predict the future leader's likely success in the context of the particular organisation and its market and reduce the risks inherent in promoting an insider or importing a talented outsider.

# 6. Board committees

## EXECUTIVE SUMMARY

- Delegation of activities to committees does not excuse the board from collective responsibility for the committees' actions; all directors should have the right to attend all committee meetings.
- The majority of audit committee members should be independent and all should have an understanding of financial matters.
- It is important to establish where the responsibility lies for the oversight of each type of risk in the business, but risk management must always remain an executive responsibility — it is the job of the appropriate board committee to monitor that it's being done effectively.
- The nomination committee's remit should be expanded to include governance matters generally.
- The remuneration committee should ensure remuneration policy is aligned to strategic goals, ensure that decisions are based on performance evaluation, avoid rewards for failure and communicate clearly the adopted principals of working methods.
- Engaging directors through participation in a strategy day is preferable to delegating all responsibility for strategy to a board committee.
- All committee advisors such as auditors and remuneration consultants should be the subject of regular competitive tender.
- The board should keep the committee structure under review, ensuring that specific industry requirements are met.

## 6.1 Committee membership

As the role and remit of the board has expanded, so has the practice of delegating specific activities to committees. Of course, responsibility for any actions taken, even if recommended or evaluated by the committee, remains with the board as a whole.

This has the advantage of freeing up the board's time for more forward-looking and strategic discussion. It provides an opportunity for groups of directors to focus on specific areas, be they audit, remuneration, risk etc. It also allows them to devote sufficient time to a proper consideration of the issues before bringing their recommendations to the full board.

The board should be careful about increasing the number of committees, given the limited availability and time of board members. There is a growing trend in some countries for all independent directors to be members of all committees, especially where outside directors number fewer than, say, six. Whilst this is an appealing idea, it can defeat the object of sharing the burden and benefiting from the synergy and focus that a subset of directors provides.

This returns us to the discussion of the optimum size of the board, which should be framed so that at least the three principal committees — audit, remuneration and nomination — can be properly staffed by independent directors.

Moreover, the concept of "everybody doing everything" wastes the opportunity for the best qualified to concentrate on their areas of interest and expertise.

That said, it should be a principle that any board director should be entitled to attend any committee meeting (without being compensated) so long as this does not reduce the efficiency of the committee's work.

## 6.2 Reporting back

It is essential that committee deliberations are reported back to the board regularly and in full. This is the responsibility of the committee chairman. A full report should include a summary of the debate on contentious issues, the options discussed and the reasons behind any recommendations. Thus, the report-back is not simply a report, it provides an opening for further review if necessary — the board must always have the opportunity to discuss in full any issues raised by the committee.

Sometimes the committee chairman's report is oral, followed some days or weeks later by the written minutes of the committee meeting. The report should be full enough for an understanding of the principal issues by all the board.

The chairman should always allow time for questions from non-committee members and encourage a measure of discussion and enquiry.

As a general principle, the agenda and minutes of every committee should be sent to all members of the board for information. However, there will be exceptions, especially when it comes to certain sensitive issues relating to remuneration and succession.

## 6.3 Audit committee

Until recently, the audit committee was often seen as the senior board committee where most public scrutiny was concentrated. Worldwide regulatory initiatives have concentrated on the role of audit committees and the approval and presentation of accounts, with the result that the remit and authority of the audit committee is more uniform and clearer than in the past. The committee's priority is to ensure that the nature of the relationships between the auditor and the company around the preparation of the accounts is rigorous, objective and not in any way compromised.

The principal tasks of the audit committee are as follows:

» to monitor the preparation and accuracy of the accounts and satisfy itself that the functions are adequately staffed to produce the necessary management and statutory accounts

» to monitor the financial controls and discipline of the company in all its aspects and, if necessary, to interrogate the operations and those responsible

» to maintain and evaluate the risk register, including any extant litigation. If a risk committee exists, then knowledge of the register is shared between committees and ultimately the board

» to set the programme for the internal audit and review its findings

» to manage and review the periodic reports from the external auditors

» to review the performance and work of both the internal and external auditors

» to recommend any changes to the external auditors and oversee the retendering process.

Many jurisdictions require members of an audit committee to have an understanding of financial affairs ("financial literacy"). In Germany, members of the audit committee must also have relevant sector experience. We believe that the chairman of the committee should be a person with a formal financial qualification and directly relevant experience, for example an auditor or a former or current financial director. There is usually a requirement that either a majority or all members of the audit committee be independent.

Most audit committees concern themselves with the financial risks present in the business or which threaten it. All risks are the responsibility of the executive to identify and mitigate and insofar as these arise from the general operations of the company. Oversight of this process is the task of the whole board.

A measure of realism is appropriate here. There are financial, operating and environmental risks that everyone can identify and agree upon. There are possible existential risks, the "known unknowns". But there are also risks that are unanticipated, the "unknown unknowns". Every organisation may be confronted by the wholly unexpected. This is not a failure in itself. It will only become a failure if the corporate response is muddled or unsure.

Risk management in such cases is after the fact. Those responsible should ensure that procedures for dealing with the unexpected are in place, with clear roles and responsibilities identified. The issue of crisis management is examined in section 8.1.

The frequency of audit committee meetings is in general dictated by the publication of company results, both at interim and final stage. However there is a growing trend for audit committees to meet more frequently than this and quarterly meetings are increasingly common. All committee members must be prepared to meet when needs require.

## Audit and risk committees — to combine or separate?

It is important to establish where the responsibility lies for oversight of each type of risk, but risk management will always be an executive responsibility — it is the job of the appropriate board committee to monitor that it is being done effectively.

A risk committee is often required in companies where the principal risk is financial, such as in the financial sector (particularly banking). In the case of industrial companies, the equivalent of a risk committee can be found in the health/safety/environment/security committee.

Where there are separate audit and risk committees, the boundaries of responsibility between the two must be absolutely clear. In such cases, it may well be appropriate for the same person to chair both committees and for there to be some joint members.

## 6.4 Remuneration committee

The remuneration committee has, at least for the present, replaced the audit committee as the principal target for public scrutiny. It is increasingly under the spotlight, attracting close attention from investors, politicians, media and other stakeholders.

The remit of the remuneration committee is simple: to set remuneration levels for executive directors and to approve the remuneration policies of the company. However, as we have seen, no committee can operate in a vacuum, especially not a remuneration committee.

Accordingly, a well-functioning remuneration committee will:

» Understand its remit clearly

» Align all aspects of remuneration policy to the achievement of the company's strategic goals and demonstrate how every decision about remuneration is consistent with this policy

» Base its decisions on individual performance evaluation and set appropriate and defensible targets

» Avoid rewards for failure at all costs

» Communicate clearly and effectively about its working methods and aims, the reward criteria, pay-out periods, etc.

» Construct simpler packages: many arrangements are over-complex if not impenetrable. Transparency alone is not a solution

» Present the CEO/senior management remuneration policy to shareholders at the annual meeting. In some jurisdictions the policy must be put to shareholders for a vote

» Be clear as to the principles guiding any exercise of committee discretion.

How the remuneration committee communicates its decisions can have a significant impact on the company. Close attention should be paid to the reputational damage that can result from unpopular decisions about CEO and executive remuneration.

We cannot stress too strongly the need for the committee to communicate clearly its decisions, and the reasons for them, to all stakeholders. This will serve to avoid many of the problems that currently beset remuneration initiatives.

It is a welcome fact that regulators' current initiatives in this area are concerned with ensuring that remuneration schemes are as simple and comprehensible as possible. Transparency is not the same as clarity.

It was once sufficient for committees to focus on the most senior executive remuneration and to declare this as "aligned with shareholder interest". The bar is now set higher and the enlightened committee will promote a policy that ensures that remuneration levels support the business strategy and other policy objectives while reflecting the corporate culture.

Issues such as pay relativities within an organisation (whether pay is uniform for the same role and does not vary by gender or ethnicity) and whether rates of pay, at all levels, are defensible both to the shareholder and the wider public audience are now finding expression in the better remuneration policies being published.

Notable in this debate is the focus on the CEO/average employee remuneration multiple — currently at a record high. While this is an oversimplified description of what can be a complex calculation, there can be no doubt that executive remuneration has been rising steeply for a generation or two. As attention turns increasingly to remuneration levels it seems we are reaching a tipping point: the challenge will be no longer "keeping up", but managing down. These are very real issues for today's remuneration committee.

All this must be framed against the remuneration committee's principal objective — to foster the growth and success of the company in the longer term. All they do must seek to promote long-term success rather than short-term reward.

The properly advised remuneration committee would normally be attended by the human resources director and/or the head of remuneration. It is common for remuneration committees to appoint remuneration advisors to keep them abreast of best practice and investor sentiment. Two observations follow: first, these advisors should be the committee's own, not the company's; second, they should be subject to a competitive tender process with at least the same frequency as are the auditors.

The degree to which the committee has discretion over awards has been the subject of much debate, and committees have been criticised for resetting targets and making individual exceptions, particularly when these exert an upward momentum on remuneration. We believe that remuneration packages should be capable of going down as well as up, depending on performance. Committees should therefore be happy to exercise discretion in the interests of a dynamic and effective remuneration policy.

Frequency of meetings is dictated more and more by regulatory requirements. The need to set targets and frame the report to shareholders generally requires at least two to three meetings a year. This might increase when the corporate remuneration policy has to be reframed. All committee members must be prepared to meet whenever circumstances demand it.

## 6.5 Nomination committee

The principal role of the nomination committee is non-executive and executive director succession, but in recent years its scope has expanded to the point where now, in many companies, it is the repository of knowledge and guidance on all matters relevant to corporate governance.

The nomination committee's principal tasks are fourfold:

First, managing board composition. This will involve succession planning, recruitment, skill-profiling and responding to current regulatory pressures. It is the committee's responsibility to define the ideal composition of the board to ensure a mix of relevant expertise and experience, as well as diversity. This responsibility includes the membership of board committees.

Second, overseeing executive director succession and ensuring that the whole board is informed of the candidates, their strengths and weaknesses.

Third, the nomination committee is often the forum for the evaluation of board performance. This includes administration of the annual performance review, consequent training initiatives, and the induction of directors, giving guidance to the company secretary whose day-to-day responsibility this usually is.

Fourth, the committee takes general responsibility for corporate governance, including oversight of potential conflicts of interest, the preparation of the governance report and, of course, the resolution of any issues that arise. It is responsible for the public reporting of the company's governance initiatives and policies.

Whilst the remit of the nomination committee differs from country to country, to have too narrow a remit would be an opportunity missed. The better nomination committees take responsibility for leading the corporate debate on matters of governance generally.

Given this expanded remit, nomination committees should consider appointing succession advisors in just the same way that remuneration committees can call on the advice of remuneration specialists.

Some companies are combining the work of the two people-related committees — nomination and remuneration — since their work is interconnected. It is too early to call this a trend, but there is a close connection between the increased scrutiny on remuneration and the people who benefit from it. Considering these two topics together might be a way forward.

Whilst meetings were originally on a needs-only basis, sometimes once or twice a year, the growing agenda and the committee's involvement in governance matters generally means that two meetings each year is now a minimum. All committee members must be prepared to meet when necessary.

## 6.6 Strategy committee

The board has a responsibility for approving corporate strategy and overseeing its proper implementation. Whatever is deemed important in terms of corporate strategy can be delegated to a committee. There, due to the focus and concentration of expertise, detailed examination can take place and an effective summary be provided to the board.

Giving oversight of strategy preparation to a committee goes some way towards avoiding the problem that many non-executive directors express, namely that they are insufficiently engaged in the strategy process.

The creation of a strategy committee should not exclude other best practices, notably an annual strategy day at which all directors are present and engaged with management.

In some jurisdictions, a strategy and investment committee focuses on work that elsewhere is shared between the board and the audit committee. The role is one of oversight and challenge as the investment proposals within the strategy obviously derive from the executive.

## 6.7 Other committees

Certain industries require specialised committees but, as we have stressed above, the number of committees needs to be compatible with the size of the board and the time available to directors.

In some sectors, health and safety issues are increasingly recognised as so mission-critical that a dedicated committee is essential both for practical oversight and to stress the significance of the issue to the organisation.

Another area that is often recognised as appropriate for committee review is the broad area of corporate social responsibility, sustainability and social impact.

The importance of reputation to business success, in both B2B and B2C industries, and the potential catastrophic impact of existential risk, are major preoccupations in boardrooms. Some see a solution in the committee structure, by monitoring and considering the "unthinkable" and then to bring their thinking to the board.

Similarly, increased business dependence on IT and the internet in all its forms, and the threats to business integrity manifested by poor cybersecurity, can benefit from the scrutiny of a board committee.

So, the best companies see the committee system as providing a flexible yet focused response to issues of the day, one that permits concentrated attention and harnesses the contribution of specific expertise among outside directors.

Ad hoc committees of the board may be set up to deal with special events, the most familiar being an approach to acquire the company or even a major investment by the company.

Exceptionally, a chairman might decide to form an ad hoc committee and invite to run it a director who is less confident of their contribution, giving this person the chance to take ownership of the topic. This can be an effective way of integrating such a person on to the board and developing their ability to play a full part.

# 7. Managing meetings

## EXECUTIVE SUMMARY

- The chairman and the board should agree on an annual programme to discharge formal and informal business.
- Any director should be free to ask for items to be placed on the agenda at any time.
- Board discussions should be actively managed by the chairman including an accurate oral summary before any item is considered closed.
- The chairman's challenge in resolving conflict is to achieve consensus without sacrificing principle.
- All board presentations should be circulated one full week in advance of a meeting and only an executive summary presented. A balance should be struck between retrospection and looking forward.
- The chairman should sit with the outside directors alone at regular intervals.
- All the recordable business of the company should happen in the boardroom and be properly minuted.
- Directors should be given easy and secure access to board papers via the internet and tablet devices and have the opportunity to store earlier papers.
- Everything must be done to correct the inevitable asymmetry of information, knowledge and familiarity in the boardroom between outside directors and executives.
- The company secretary or similar should be the conduit for advice to the board.
- Directors should be supported in taking external advice at the company's expense whenever they feel it appropriate.

## 7.1 The board agenda

A board meeting is clearly the chairman's meeting, but the framing of the agenda is generally a joint effort between the chairman and the CEO. In this way, issues relating to both the company's operation (internal) and its governance (external) get on to the agenda.

The chairman and the board should agree an annual programme of issues to be brought to the board. It is at this stage of framing the annual agenda that the contribution of the directors is most useful. Subject to that, any director should be free to ask for an item to be placed on the agenda at any time — this right is protected in most legal systems.

The benefit of an annual programme is that it ensures all relevant operational and strategy issues receive a regular hearing and, most importantly, that the specific responsibilities of the outside directors are identified, exercised, debated and recorded.

## 7.2 Strategy

In recent years, it has been a common complaint of board members that the preoccupation with governance has resulted in less and less time available for the discussion of strategy. Moreover, as we have observed, the lack of opportunity to make a meaningful contribution to the development of strategy has long been a frustration for outside directors, particularly in those countries where there is an expectation that the final strategy is the product of boardroom debate. Too often, strategy has been presented fully formed, with the contribution of outside directors limited to monitoring its proper implementation.

In a two-tier board system, the authorship of the strategy is clearly the responsibility of the executive. The role of the supervisory board is to provide constructive challenge and support and to monitor successful implementation of the strategy. Indeed, in Germany the supervisory board is expressly forbidden from involving itself in the creation of strategy. Elsewhere, directors increasingly see themselves in an active role, not just a supervisory one, and as a result expect to have greater involvement in framing strategy.

In the unitary board system, there is a clear expectation among non-executive directors that they will be closely engaged in the strategic-thinking process. This should include an understanding of the full context in which the strategic options were framed and reasons why some options were rejected.

Executives should be focused on the operation of the business, but the outside directors are required to have a 360-degree vision. Often it falls to outside directors to strike the balance between short-term performance and long-term strategic commitments, and to help articulate that balance to stakeholders.

As noted above, the first priority should be to establish where responsibility lies for strategy and what the respective roles of executives and outside directors are. For example, historically the role of the board has been to advise, approve or reject but not to design strategy. Today, the board must be more engaged in strategy development. A strategy committee is one such solution. Alternatively, strategy is increasingly an agenda item for full board discussion in the lead-up to the strategy meeting.

An annual strategy day is essential and is now best practice. This should be held outside the regular schedule of board meetings, but of itself this is not enough. Strategy, in its broadest sense, is no longer a matter for a one-day debate. The best boards seek mechanisms whereby outside directors can contribute their wider perspective to the framing of a company's strategic direction and purpose.

Strategy is not created in a vacuum and is rarely static. Strategy must evolve through an iterative process at board level, taking account of changing circumstances, competitive disruption and fresh commercial challenges. Specific strategic initiatives such as an M&A transaction, a substantial investment or product launch, however, should always be subject to a rigorous post-mortem at the board.

## 7.3 Quality of debate

Good debate does not happen by accident. It requires active management by the chairman and mutual trust between directors who must feel that their contribution is neither taken personally nor disregarded. Equally, no one person should seek to, or be allowed to, dominate the debate. For real discussion to take place, all directors must be receptive to alternative points of view.

Sufficient time must be allocated to debate. Frequently, presentations by executives take too much time and repeat what is in board materials, with the result that discussion is not focused on the pressing issues. An executive summary or list of issues can help to focus the discussion. Presentations may be important for educating the board about complex business matters, but they should avoid repeating what is in the board papers.

Executives want to benefit from the mix of expertise around the boardroom; they want to be advised, not merely monitored. Non-executives want enough opportunity to share their insight and to discharge their responsibilities.

At the close of the debate, the chairman should ensure that all aspects of the issue have received attention and, once that is done, should summarise the principal points made and reflect the prevailing view. The responsibility of the board is collective; the quality of the debate and the way it is recorded are vital.

## 7.4 Meetings

Some boards have monthly meetings lasting three to four hours, while others choose to have longer meetings every two months.

Simple logistics may dictate that boards with an international membership are best served by fewer and longer board meetings.

Most companies now make full use of the freedom to conduct virtual meetings — assuming the company's governance rules allow it.

Some may say that there is no real substitute for face-to-face engagement, but time and diary pressure means that attendance in person is not always possible. So some amount of "virtual" attendance is permissible, especially as attendance is now monitored and disclosed in many jurisdictions.

Businesses are complex mechanisms and the board's responsibilities can only be properly discharged by frequent interaction with the company and its management. However, frequency is an elastic concept, stretching from two main board meetings each half year (the minimum mandated by German law) to one every month. The average number of scheduled board meetings for different countries can be found in the chart below.

Of course, events may dictate that meetings become more frequent at times of M&A, existential threat, etc. Weekly board meetings are not uncommon at such times, with more frequent meetings often being held by specifically constituted ad hoc committee.

## Scheduled board meetings (average per year)

| | # | | # | | # |
|---|---|---|---|---|---|
| Belgium | 8.6 | Italy[2] | 11.6 | Spain | 11.3 |
| Denmark | 8.6 | Netherlands | 11.6 | Sweden | 9.2 |
| Finland | 12.2 | Norway[3] | 10 | Switzerland | 11.1 |
| France | 9 | Russia | 6 | UK | 7.7 |
| Germany[1] | 6.7 | | | | |

1 Germany requires a minimum of four board meetings per year by law
2 Italy has no minimum number of meetings but requires the CEO to report to the board quarterly
3 Norway requires a minimum of two board meetings per year by law

## 7.5 Meeting materials

Above all, the policy for meetings should be that there are no surprises.

All board presentations should be circulated at least one full week before the meeting and only an executive summary presented during the meeting, in order to maximise discussion time. A balance should be struck between retrospection and looking forward; the rear-view mirror is important, but setting the direction of travel is more so.

Directors should be given easy and secure access to board papers via the internet and tablet devices and have the opportunity to store earlier papers. However, if individuals are more comfortable with traditional papers, then they too must be accommodated. Board administration is not designed for the convenience of the executive.

There is an increasing demand for more concise board papers, executive summaries and presentations. This way, questions are raised to stimulate the debate rather than offering lengthy descriptions. Too much detail in board papers can lead to a lower quality of debate, because directors end up spending too much time examining the detail and not enough considering the bigger picture. A clear understanding of the distinction between the detail provided as background and the issues to be debated during meetings is essential.

Standardisation of presentations can be helpful here. First, many agendas indicate the time available for each discussion. This requires some discretion and common sense from the chairman. Second, papers are often marked “for information", "for discussion" or "for decision" or similar. This will also relate to how the agenda is framed, with less significant items coming at the end.

Each board should develop a common framework for board papers so the lay-out becomes familiar: for example, an executive summary, a substantive paper (which should be as short as possible) and background material relegated to appendices.

Even though the movement to electronic media does not appear to have reduced the volume of material for directors to read, there is growing pressure from many chairmen for board papers to be no more than a few pages long, with points for discussion and decision clearly highlighted.

That said, the information available to directors should not be limited to formal board meetings but should include a regular flow of material, including management accounts, analysts' reports, presentations made on behalf of the company, media coverage and all significant announcements, both internal and external.

## 7.6 Meeting locations

Most boards benefit from seeing more aspects of a company's operations than are encountered at head office. Many boards seek to meet from time to time outside the corporate headquarters and in an operational location, either domestic or overseas.

Indeed, the annual overseas visit has become a staple of many companies' boardroom operations. Obviously, the ease and opportunity for such visits depend on the structure and international scale of the business, but the simple point is this: nothing makes a more positive contribution to corporate morale, or makes the board more visible and relevant, than its presence at the operational core of the businesses.

## 7.7 Social dynamics

Boards are social constructs and some element of social cohesion helps the debate.

A word of caution here. It is a legitimate ambition that fellow board members should view each other as valued colleagues; however this is different from viewing them as personal friends.

The best board relationships are characterised by collegial professionalism. Some chairmen believe that social events generate cohesion among board members and create the kind of atmosphere in which debate can thrive. So it is commonplace these days for board meetings to be preceded (or followed) by dinners. These settings provide an opportunity for less formal discussion and are often used to expose directors to members of the executive they might not otherwise encounter — all part of long-term succession planning.

A mingling of personal lives is less common, but in some countries chairmen think it helpful if there is at least one event a year when directors and their partners are together — this is a growing trend and part of humanising the board.

## 7.8 The non-executive directors' meeting

The non-executive directors' meeting — where the chairman sits with only the outside directors — is a growing feature of good governance. It provides an opportunity to raise issues of concern without the executive team present.

### Meetings of the board without executives present

BELGIUM
At least once a year

DENMARK
Not applicable — two-tier system

FRANCE
At least one per annum

GERMANY
Not applicable — two-tier system

ITALY
At least one per annum of the independent directors

NETHERLANDS
Recommended in the code but no prescribed number

NORWAY
Recommended and common practice to have a short meeting at the end of each board meeting

SPAIN
Not specified

SWEDEN
Not specified

SWITZERLAND
No legal requirement; companies sometimes prescribe one to two per annum in their statutes

UK
Code recommends that chairman meet with independent non-executive directors and also that the non-executive directors meet without the chairman at least annually, a meeting usually chaired by the senior independent director

Sometimes such sessions precede the board meeting. More often they follow it, which is more logical because the agenda often will be driven by issues arising at the meeting. Some companies favour less frequent meetings, often in a more relaxed setting.

While this is easy to accommodate in the two-tier structure, unitary boards must be careful to avoid a “them and us” division between outside directors and executives.

In our view, the opportunity for directors to have a conversation involving exclusively the “outside” perspective is of great value.

## 7.9 Keep it in the boardroom

Confidentiality is vital to boardroom discussions. All directors must feel free to speak without risk of their views or the board discussion being reported other than through the medium of the formal minutes or some other authorised communication.

It is often said that some of the most effective problem-solving on a board is done outside the boardroom, in the corridors or informally elsewhere. This ebb and flow of discussion is helpful, but it is far more important that the formal record of the board’s deliberations — the audit trail — is visible and secure. This is only possible if all material interactions take place in the boardroom. All directors should be alert to this requirement. Transparency dictates that the major discussions and decisions are subject to proper record and minute-taking.

## 7.10 Resolving conflict

Conflicts must be resolved before consensus can be achieved.

It is the chairman's job to manage conflict on the board. It is our experience that a dysfunctional board is generally a sign of a weak chairman.

A strong and effective chairman will encourage an open and honest discussion, will tolerate disagreement but will understand that the discussion must end in consensus.

It is interesting to note that voting on the board rarely happens in practice.

The risk all boards face is that consensus can mean taking the path of least resistance. Perhaps the hardest challenge for the successful chairman of any meeting is to bring issues to the surface, permit disagreement, confront the arguments and yet achieve consensus without sacrificing principle.

The ultimate protest for the director who cannot support the decision is resignation. It is surprising how little this sanction is used (although it is possibly more frequently threatened). In some cases, this may be because boards prefer consensus to confrontation — even when they believe executives could be wrong.

Some outside directors are reluctant to surrender their position on the board, even on a matter of principle. This is the wrong attitude. An outside director should not assume a long, untroubled life. The freedom to walk away is essential; there is no shame in a clear disagreement openly recognised.

It is telling that few of the corporate catastrophes of recent years have been preceded by visible board turmoil. Were the boards complacent or ill-informed about the gathering storm?

## 7.11 The knowledge gap

Outside directors might spend a maximum of 30 days on the business, while executive directors are on the case 24/7 — but both sets of directors are accountable 365 days of the year. By definition, the executives have knowledge of, and access to, information concerning the company which the outside directors can never match.

This asymmetry of information is most keenly felt on unitary boards, where outside directors and executives take equal responsibility for decisions based on different levels of information and understanding. However, it is also relevant in two-tier boards when the job of supervision will depend crucially on the quality of information made available to the supervisory board.

To use an analogy from a court of law, the board papers are the evidence and the meetings are the opportunity for a cross-examination of the principal witnesses.

The essential point is that the flow of paperwork to the board, and the chance to interrogate and question in a constructive manner, is the opportunity for the outside director to rebalance the information deficit.

This underlines the importance of a commitment on the part of the outside director to understanding the company and how it works — not just in and around the board meetings, but constantly.

## 7.12 The company secretary's contribution

The most successful boards are those that are administered well. Responsibility for this often falls to the company secretary, general counsel or head of secretariat — the title varies but the responsibilities do not.

The role of company secretary (or similar) has grown in recent years, as has the reputation of the function. In some jurisdictions, their authority and position is protected by law.

The board will require advice both on the legal implications of its operations and on issues of corporate law, practice and governance.

In larger organisations these separate strands of advice are given by different individuals. The general counsel or chief legal officer is responsible for operational legal advice, often reporting directly to the chief executive; the company secretary is responsible for governance and compliance and often reports directly to the chairman.

The current trend is towards this separation of roles, given that the scale and complexity of regulatory compliance has increased so much in recent years. But this is not an inevitable result. Single point responsibility for all legal matters is, in our view, the better way. Company secretary expertise can be located in individual members of a legal team, with one person responsible overall.

It is best practice for companies to support directors in taking independent advice, at the company's expense, whenever they feel it appropriate to do so. In some jurisdictions this right is enshrined by statute. This is a recognition that, on occasion, the interests of individual directors and those of the company itself might diverge.

# 8. When things go wrong

## EXECUTIVE SUMMARY

- The board must remain in charge and provide the lead, not the advisors.
- Response should always be rapid and proportionate and guided by the principle of full disclosure, regardless of short-term considerations.
- To be prepared for the assault of the unhappy shareholder, boards must be their own fiercest critic, think the unthinkable and take the message seriously (it is free advice).
- Litigation risks are real. All directors must approach their task responsibly, taking independent advice and giving adequate time and consideration to the issues. Such an approach will discharge their responsibility.
- Always ensure that comprehensive directors' and officers' (D&O) liability insurance is available.

## 8.1 Crisis management

That crises will occur is inevitable and boards should be prepared to deal with them. However, the more successful the company, the harder it is to generate enthusiasm for crisis planning.

The best planning is specific and related to identifiable risks, even if it turns out that the actual crisis is unrelated to anything seen on the risk register. Advance planning should be led by the risk committee, if one exists. If not, either the appropriate board entity should take the lead, for example the audit committee, or the lead should be given by the full board.

Applying the principle of making your friends before you need them, the best advice is to build good political and regulatory connections in your most important markets. Take care however that political links are non-partisan and encompass all political interests likely to be relevant not just now but in the future.

Response should be rapid and proportionate. The speed and quality of response in the first few hours/days of a crisis will have a lasting impact.The board must lead the agenda; don't leave it to advisors, government or the press. First-class advisors are important and boards should never be embarrassed about taking and paying for the best advice. However, having advisors does not relieve the board of responsibility for its decisions. The board should remain in charge at all times.

### Behaviour in a crisis

- First establish whether this is a crisis of character or competence. That will dictate what you say and how you say it
- Your response should be transparent and truthful. If you don't yet know the truth, say so and don't speculate
- Take action as soon as possible; any delay will be seen in a negative light
- First reactions will have long-term consequences; listen to external voices but make your own choices
- Which of your managers have the temperament and skill to deal with specific crises? These will not necessarily be the man or woman at the top
- Never declare victory; it is for opinion outside the company to decide whether the crisis is over
- Remember that a company can be made great through the way it responds to a crisis.

## 8.2 Shareholder activism

Shareholder activism can be divided into two broad categories, the active investor and the shareholder activist.

Thus, at one end of the spectrum are institutional shareholders, often with a long-term holding strategy. Their interventions will most often be challenging yet supportive. Nevertheless, there have been occasions when institutional investors have been responsible for unseating incumbent CEOs, most often in the context of pressing for a more rapid implementation of existing strategy.

The reason for this development is simply that with a market increasingly comprising indexed funds, these funds do not have the opportunity to sell the shares — they must remain holders and therefore require a level of engagement and influence on management to protect their interests.

At the other end of the spectrum are the so-called “activist investors” who take opportunistic positions in existing companies, having identified unrealised value resulting from a poor strategy or suboptimal management. Again, these investors have appeared because they are chasing yield in a low interest rate environment — one that has prevailed for at least a decade.

Boards should assume that most shareholders of any size occupy a position somewhere on this spectrum. The issues that attract the attention of activists may be a combination of unambitious strategy, an under-geared balance sheet and long-tenured management.

The board should therefore bear in mind the following advice:

» Be your own fiercest critic. Anticipate the case that might be made against you, keep all your options constantly under review and prepare your response.
» Think the unthinkable. How does the incumbent contemplate the kind of disruption that the objective, dispassionate outsider can envisage as necessary?
» The board needs to disengage from its emotional investment in the status quo and the current strategy in order to match the objectivity of the analytically driven activist.
» When approached by an investor-turned-activist, take what they say seriously. They will have done their homework. It is free advice.

- Increasingly, the focus of attention will be the board itself — its leadership, composition and effectiveness.
- Be open-minded when confronted with a demand for board representation. Each request should be considered on its merits. The board's response should be framed by the investor's attitude to the long-term health of the business.

## 8.3 The human dimension

Directors must be prepared to experience some tension and to manage the way in which they question the executives and interact with fellow directors. Things cannot always go well, for example, when their personal relationship with colleagues and/or the chairman has fractured or their role and the way they discharge it is in question.

In this instance, the director should consider the true nature of the problem. Is it a matter of personal relationships and is the situation recoverable? More importantly, is the breakdown so severe that the director's contribution is now ineffectual or negative?

If the director finds him or herself out of step with the board's ethos and modus operandi, then an honest conversation with the chairman or senior independent director is essential. Preserving the collaborative spirit of the board is important, but the value of the grain of sand in the oyster should not be lost.

## 8.4 Liability

Directors' liability used to be a significant consideration for those proposing to join a board. When meetings were infrequent and the asymmetry of information was acute, this was a legitimate worry.

In these days of more frequent meetings, enhanced professionalism at board level and greater levels of commitment and involvement, these worries have receded somewhat. Add to this the increased due diligence undertaken by directors before joining a board and one might assume the issue has gone away.

On the contrary: the increasing availability of legal remedy to shareholders through class or derivative actions, allied to a high level of public scrutiny and expectation, means that litigation risks are real.

## 8.5 Legal consequences

In all legal systems, directors are expected to execute their duties in good faith and with due diligence, at least to a standard expected of a person with their particular experience. It is sometimes said that if directors meet these expectations, then they need not worry about legal liability. In other words, directors are allowed to be wrong, but not reckless or negligent. Provided their opinions are properly thought through, honestly held and expressed, then the director's duty is normally considered to have been discharged.

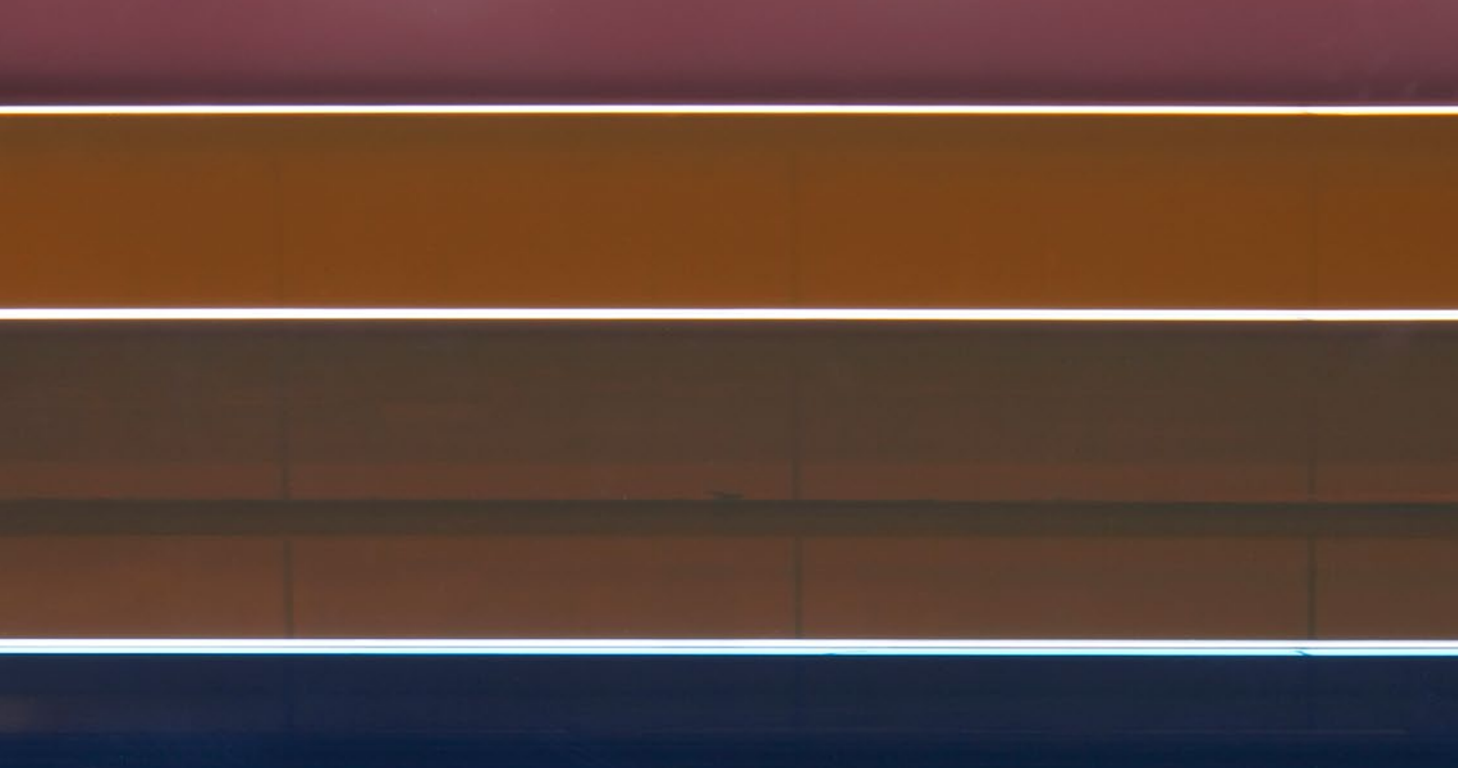
This does not prevent a director or a board facing legal action from shareholders and others seeking to prove negligence. Legal actions of this kind, often originating with investors hoping to replicate a US-style of jurisprudence, have recently been made easier by developments at both European and national levels.

Potential directors should be alert to the risks, but not alarmed. Approaching the director's task responsibly — by devoting adequate time and giving all issues full attention — is the best defence.

## 8.6 D&O insurance

Proper behaviour will ultimately defeat a legal assault, but what happens in the meantime? Defending actions brought against directors will be an expensive and troubling business. The provision of directors' and officers' (D&O) liability insurance, paid for by the company, is of real comfort here — and directors should always insist on it.

This will ensure, at a minimum, the payment of all legal expenses and fees incurred in defending an action. The responsible director should have little to fear if a good D&O policy is in place.



# 9. Measuring performance

## EXECUTIVE SUMMARY

- Annual board assessment is essential; however constant self-evaluation is the best practice.
- Internal assessments can never be sufficient — regular independent and objective evaluation of behaviour and effectiveness are vital: at least every third year and following significant change.
- External evaluation should be conducted by professionals with a knowledge of best practice and the appropriate technical skills.
- Individual evaluation of a director's performance is desirable.
- The performance of the board should be the subject of a report to shareholders.
- Disproportionate rewards for outside directors will compromise their independence.
- Outside directors' fees are best paid in salary, not shares.

## 9.1 Measuring board effectiveness

Public expectation of board performance is increasing and boards must be ready to demonstrate that they are both fit for purpose and self-aware.

Just as directors are required to be more professional in the performance of their duties, so the monitoring and evaluation of that performance sets a good example to the organisation as a whole. It reinforces a culture of self-reflection and openness to constructive criticism.

How effectively the board carries out its duties should therefore concern every board member, not just the chairman.

An annual board assessment plays a critical role in ensuring that any problems in how the board functions are brought to light and addressed in a discreet and timely manner. Board assessments frequently result in improved processes, more accountability and transparent communication, enhanced trust and better decision-making.

Clearly, multiple factors contribute to board effectiveness, from the chairman's leadership and board composition to the quality of the information provided to directors and the nature of debate. The CEO's attitude and receptiveness is also relevant.

These annual evaluations are frequently self-assessments, often conducted by questionnaire under the direction of the deputy chairman, senior independent director, or often the company secretary. Frequently, the results are referred to as part of the governance report published by the company.

A board should discuss how it will measure its own effectiveness and what it needs to address, for example:

» What are the key issues for the company? Does the board address the needs of the business, rather than simply governance or regulatory matters?
» Is the board ensuring that sustainable value is created and competitiveness assured?
» To what extent does the board adhere to or surpass local governance recommendations?
» Is the board working well as a group? Is each individual board member fully effective?
» Is there trust and collegiality among directors and between the board and the management team?
» Are the board committees effective and do they keep the full board properly informed about their work?

Boards should not expect too much of an internally managed board assessment exercise. Self-criticism is likely to be muted and any changes recommended will be modest — a weakness of self-regulation. Those who mark their own home-work are likely to award high grades.

### The ingredients of a successful board assessment

In our experience, clients derive the highest value from an external board assessment when the approach pursues the following key principles:

- The assessment is specifically tailored to the client's current business context
- The scope is determined on the basis of a comprehensive briefing by the chairman and agreed stakeholders
- Board members are interviewed individually on a confidential basis and asked both for their qualitative and quantitative assessment of the areas that determine board effectiveness
- The board's performance is benchmarked against equivalent companies
- The assessments are conducted by consultants of seniority and experience.

## 9.2 External facilitation

To provide greater rigour in the area of board assessment, we recommend an externally facilitated exercise — at least once every three years. This appears as a governance code recommendation in some jurisdictions. In some markets externally facilitated evaluation happens annually.

An external assessment conducted by an experienced and neutral facilitator provides a far richer and more nuanced picture of the board's functioning and effectiveness. Most importantly, it is more likely to provide a true and honest one.

The identification of substantive issues and the ability to benchmark the board against best practices elsewhere are the two principal reasons why an external evaluation can provide the information that shareholders and other stakeholders seek.

A well-conducted external assessment of the board will have a number of objectives going far beyond simply reporting on how things are.

A key ambition will be to enhance the board's relationship with management and to ensure that communication among directors and with the executive is more transparent. An ambition will be to improve the board's processes of working together with an aim of building trust among directors, thus allowing for better decision-making, particularly during periods of crisis and transition.

There is real benefit in board assessments being done on a consistent and regular basis. It helps set the right tone at the top and many high-performing boards consider an externally facilitated annual board assessment to be best practice, not least because it enhances the recruitment process.

An effective performance evaluation requires expertise and professionalism on the part of the evaluator. Given the growing legislative requirements for external evaluation, an increasing number of individuals and organisations are offering their services. However, for the best results boards should choose as an external facilitator a firm that has the resources and experience to do the job properly. Each evaluation should be conducted by a specialist in the field of board and corporate behaviour that offers these services across many jurisdictions, bringing experience and best practice from other relevant markets.

## The case for the leadership consultancy as board assessment provider

There are at least three reasons why such a high-quality consultancy should be appointed:

- It will have a unique perspective on boardroom composition and has the data to provide meaningful benchmarks
- Boards are open increasingly to learning from governance practices in other jurisdictions, and a global consultancy can provide recommendations based on international best practice
- It has access to behavioural expertise and professional analysis of what works well and makes an effective board.

The experience and depth of boardroom expertise available from a leadership consulting firm is precisely the skill set required to perform a proper board evaluation.

Could such firms be conflicted when seeking to provide a board evaluation service, at least to their existing clients?

The answer is emphatically not. Such potential conflicts are commonplace in professional services and successfully dealt with by erecting clearly understood information barriers. Organisational separation ensures an absence of conflict.

## 9.3 Individual evaluation

Just as executives are subject to annual performance reviews, so the individual performance of outside directors has become the subject of regular evaluation in some countries.

These often take the form of peer reviews. As part of the annual board assessment, opportunity is given to directors to comment, indirectly, on the contribution of their colleagues.

This is an emerging practice, but as the role of the outside director comes to be seen as a distinct function (and sometimes a career choice) so their performance and contribution will be judged on an annual basis, just like that of any other professional or executive within the organisation.

However, the annual review should be regarded only as a summary of what is in fact a constant evaluation of the board's performance. A good chairman will be alert to how the board and individual directors are performing and should be quick to intervene when needed.

In this respect, we urge all boards to be self-aware all of the time — rather than only turning to this issue once a year.

If an individual is failing to contribute in the way that is expected of an independent director, it is the chairman's responsibility to advise on how the individual's behaviour and contribution can be changed, just as any other executive would be managed. Persistent under-performance will inevitably lead to departure.

The chairman's own performance should not be overlooked. It is best included as part of the annual review and is normally led by the senior independent director or deputy chairman.

## 9.4 Reporting to shareholders

The performance of the whole board should be the subject of a report to shareholders, as a matter of principle. The report should detail what evaluation has been made and, where required, what remedial and/or developmental steps the board will be taking.

This obligation is best met by the nomination committee, and the resulting analysis will either be included in the nomination committee's report to shareholders or in a more general section on corporate governance — both of which appear in the annual report.

## 9.5 Non-executive remuneration

The increasing demands on directors in terms of time commitment and responsibility has led to a gradual, though small, increase in the level of fees paid to outside directors. By contrast, there has been a marked increase in the remuneration of executive directors.

The growing scrutiny and scepticism surrounding levels of executive reward has already spilt over to board remuneration more broadly.

It is important that levels of reward for outside directors should be reasonable and defensible. Fees should be commensurate with the time directors are required to devote and the scale and impact of the business. However, the overriding requirement is that outside directors should remain independent of the organisation on whose board they serve.

A few philosophical questions arise when thinking about non-executive director remuneration, for example:

» Can an outside director who relies exclusively upon director's fees from a single organisation ever be construed as totally independent?
» If an outside director is rewarded on a similar basis and on the same metrics as the executive, how can their judgement ever be objective?

Board director remuneration is a matter for each company to decide. It should be a matter of common sense to determine when remuneration levels are too high relative to the salaries within the organisation and to remuneration in society at large.

Indeed, any organisation with an opaque governance structure but with high rewards on offer should be avoided by the responsible outside director.

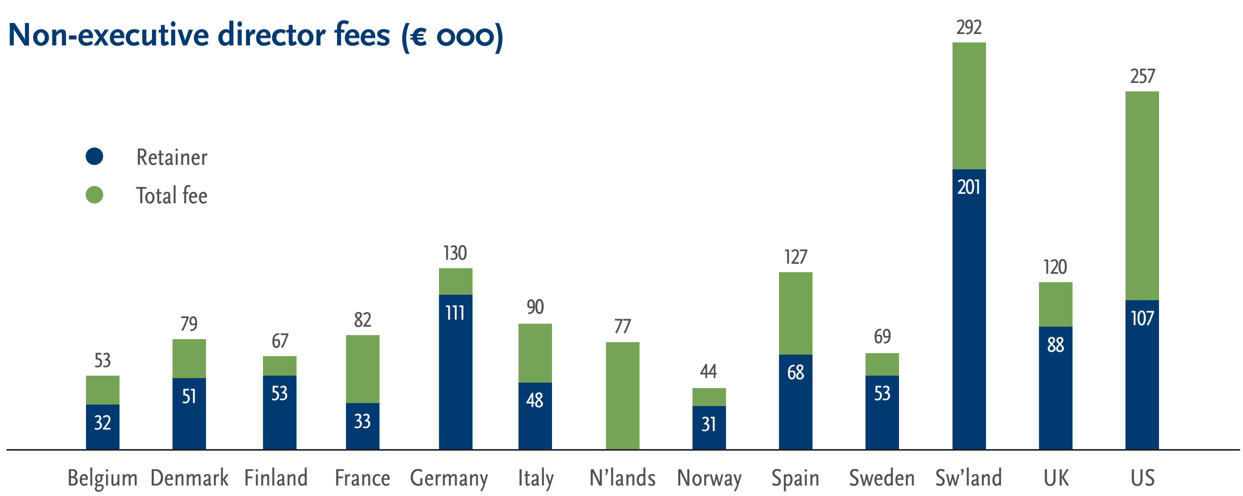
The issue of rewarding non-executive directors with shares provokes strong opinion. Some investment institutions oppose this practice on the grounds that it may lead to the directors adopting short-term views. Others object on the grounds that share price performance may not be linked to corporate performance. On the other hand, proponents claim they are only aligning their own rewards with those of the shareholders themselves.

The principal risk we identify is that this very alignment contains the seeds of its own destruction. If the aim of the board is to promote the long-term success of the company, part of the role of the outside director is to ensure that the executives do not take short-term measures to inflate the share price and their own rewards.

If the directors share in those rewards, they are compromised in performing one of their central duties. For this reason we would recommend that boards should consider carefully whether it is appropriate for outside directors to be rewarded in shares.

An acceptable measure of alignment is best achieved by requiring each director to purchase shares to a value of at least their annual fee. Some companies choose to disclose the shareholdings of all directors, executive and non-executive, including the growth in value of those shares since purchase.

## Non-executive director fees (€ 000)



# 10. Beyond the boardroom

## EXECUTIVE SUMMARY

- Trust in business, for now and in the foreseeable future, will have to be consistently and continuously earned and re-earned.
- Boards should acknowledge the social contract whereby their licence to pursue profit is conditional upon their not causing social harm.
- Boards should understand what the current culture is, how well it is aligned with strategy, how far it falls short of an ideal and how it features in succession plans and executive evaluation.
- Companies should offer a coherent and full explanation of their governance approach, their purpose and their relationship with society and approach to sustainability.

## 10.1 Corporate trust

One could point to numerous recent cases of corporate malfeasance that have fuelled cynicism and mistrust of business in the public mind.

This undermining of the pillars of business and the institutions that sustain them, both political and regulatory, is a challenge to boards of directors.

If confidence and belief in business is currently being withheld it will only be extended again in return for a clear demonstration that business is worthy of public confidence and belief. Trust in business has to be consistently and continuously earned and re-earned.

Underlying this failure of trust are concerns about the consequences of globalisation, executive remuneration, the commitment to sustainability and to the societies in which companies operate, and a clamour for greater transparency.

So, on the one hand society questions the long-term commitment of corporations; on the other, boards have to satisfy the short-term demands of the markets to which they are answerable.

This is the challenging context in which boards must operate.

## 10.2 Social impact

Companies cannot be judged in isolation — they exist only as part of a social framework and they will survive only for as long as they retain the confidence and trust of the societies in which they operate.

Companies will thrive if they acknowledge a social contract whereby their licence to pursue profit is conditional upon their not causing societal harm. Consequently, the informed board of directors will take responsibility for, and have oversight of, the company's social impact.

In this it will have to be conscious of the views of government, non-governmental organisations and other stakeholders well beyond the traditional list of boardroom priorities.

Boards of directors are today expected to understand the consequences of corporate action and to be able to articulate the benefits of corporate activity outside those accruing to shareholders. We are now in the world of the social audit, which is permanent and ongoing.

The proper discharge of corporate responsibilities should be pursued in an ethical and socially aware manner whilst ensuring a profitable return for investors and equitable treatment of all stakeholders. It is the kind of challenge a good board will relish.

## 10.3 Overseeing company culture

Boards can help to foster long-term shareholder value by deepening their understanding of their company's culture, placing it on the board agenda and ensuring management is forging a culture aligned with the business strategy.

A company's culture can make or break even the most insightful strategy or the most experienced executives. Effective cultural patterns can produce innovation, growth, market leadership, ethical behaviour and customer satisfaction. On the other hand, a damaged culture can impede strategic outcomes, erode business performance, diminish customer satisfaction and loyalty, and discourage employee engagement.

We have found the following questions to be powerful in helping directors better understand culture and ensure the company is on the right path.

### WHAT IS THE CURRENT CULTURE OF THE ORGANISATION?

Culture is the culmination of the shared values, beliefs and assumptions that shape the behaviour of the organisation. These "unwritten rules" guide the thousands of decisions employees throughout the company make every day. Boards should ask: What are those unwritten rules that everyone just knows but can't necessarily articulate clearly?

### HOW WELL-ALIGNED IS OUR CORPORATE CULTURE WITH OUR STRATEGY?

A high-performing organisation with a strong alignment between culture and strategy produces better financial growth and employee engagement. Boards should ask: What organisational behaviours are required to achieve our strategy?

### WHAT IS THE DIFFERENCE BETWEEN OUR CURRENT AND IDEAL CORPORATE CULTURE?

Effective leaders can describe both the culture as it currently exists and the culture to which the organisation aspires. This ability is sometimes called "cultural fluency," and it is a critical skill for leading on culture. Boards should ask: What cultural impediments do we face and how will we overcome them?

### HOW DO WE CONSIDER CULTURE IN OUR SUCCESSION PLANS?

Culture evolves over time. Boards will want to understand how talent management systems, employee evaluations and executive recruiting are likely to shape the future culture of the company. Directors should ask, to what extent do individuals' leadership styles contribute to the culture we strive to achieve?

### WHERE ON THE BOARD AGENDA SHOULD WE PUT QUESTIONS ABOUT CULTURE?

Given their current demands, boards are unlikely to tackle questions about company culture unless the issue is explicitly part of the agenda. So where on the annual board calendar should culture fall?

By placing culture on the board agenda and asking the right questions, boards can help to ensure that culture supports business strategy, while preserving the boundary between governance and management.

## 10.4 Defining the company's purpose

Boards would be well advised to tackle this issue before regulators create a framework for them to do so.

Recent governance debate in Europe has raised questions both as to the level and scope of reporting of general activity and explanations of specific governance compliance.

In our experience, the market is increasingly looking for a statement from the chairman and the board about how the company is being run and what its long-term ambitions are. Some regulatory regimes require that reports to shareholders and others should contain this overview as part of the board and management commentaries. This seems to be a good trend: it demonstrates that the board has thought about the issue of the company's significance to society as a whole.

Just as deeper and better explanation of a company's general purpose is now required, so too is a closer explanation of adherence to corporate governance precepts and best practice.

Explanations should be specific to the company's position and not generic or off the shelf.

The European Commission's original intention of making corporate governance statements "regulated information" is in abeyance. There is still a possibility that regulators, rather than shareholders, might eventually have the task of deciding whether an explanation for non-compliance is sufficiently complete.

In our experience, companies that offer a coherent and full explanation of their corporate governance approach are more likely to find their explanation is readily accepted when they do choose to deviate from a particular provision.

# Conclusion

As we said at the start of this document, few endeavours are more fulfilling than serving as a director on a board alongside committed and stimulating colleagues. The responsibilities of directors will only increase, along with the significance of their role. There is no better place to be than at the centre of events and we trust that this overview of best practice in the boardroom will help the reader make a telling contribution to the success of his or her enterprise.

If you have questions about any of the recommendations in this publication or would like to discuss any of the ideas expressed here, please contact a member of our European Board Practice who would be delighted to hear from you.

Spencer Stuart offers a range of services relevant to the issues raised in this publication, including:

**Board Advisory:** We advise board and committee chairmen on governance best practices and counsel them on succession planning, director orientation and ongoing education.

**Board Assessment:** Using a methodology refined over many years, we customise board assessments for clients around the world that result in more effective, higher-performing boards.

**Director Recruitment:** With our unparalleled access to and knowledge of the candidate pool, we help place outstanding directors who add value to the boards they join.



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# Appendices

## A. Further reading

Spencer Stuart has been publishing annual Board Indexes around the world for over 30 years. Spencer Stuart Board Indexes provide a unique analysis of the latest data and trends in composition, committees and director remuneration among the largest boards in each of the following countries:

Belgium

Brazil

Canada

France

Germany

Hong Kong

India

Italy

Japan

Netherlands

Nordics (Denmark, Finland, Norway, Sweden)

Russia

Singapore

South Africa

Spain

Switzerland

Turkey

United Kingdom

United States

In addition, we regularly publish articles and papers on a wide range of topics relating to boards and board governance. Here is a selection:

» Investors and the board

» The five most common new director questions: Advice for first-time board directors on getting a strong start

» Performance in the spotlight: Assessment and board effectiveness

» The four biggest hidden CEO succession risks and how to avoid them

- » Questions boards should be asking about corporate culture
- » Technology in the boardroom: Five things directors should be thinking about
- » Cybersecurity: The board's role
- » Governance in focus: How boards can respond to heightened investor expectations
- » Global Board of Directors Survey
- » Becoming a non-executive director

More board-related articles, videos and audiocasts are available on www.spencerstuart.com.

## B. Directors' Forum

First launched in 1995, the Spencer Stuart Directors' Forum is a unique educational programme that uses role play to provide the opportunity for potential and actual directors to develop their boardroom skills and better understand board process.

This is done by working alongside highly experienced leading figures from top corporate boards as a prompt to learning and exchanging best practice.

The programme revolves around 18 months in the life of a mythical company. Over the course of two days, a number of board and board committee meetings are staged and events unfold — some scripted, some not, but all informed by real life. The faculty are joined by the participants who play the role of non-executive directors to tackle the issues the company faces.

The Directors' Forum faculty consists of the chairman, chief executive, finance director, chairman of the audit committee, chairman of the remuneration committee and chief legal officer. These roles are all played by leading business personalities, all of whom hold these exact positions in major publicly quoted companies.

Participants, who are carefully selected, typically fall into one of the following categories:

- Experienced executive directors who are seeking non-executive director positions or who simply want to broaden their knowledge of boardroom behaviour
- Recently appointed directors, both executive and non-executive
- Directors of subsidiary boards of major companies seeking to gain a better understanding of the issues dealt with by a public company board, perhaps prior to their appointment to the main board
- Senior figures from a variety of backgrounds, for example the public sector, wishing to join a public company board.

The programme is supported by a group of key advisors, all leading practitioners in the fields of banking, law, accountancy, media relations, etc., who both advise the company as role players and share their experience.

Spencer Stuart runs Directors' Forum programmes annually in both the UK and Germany.

All participants in the Directors' Forum join an alumni group, providing a ready-made network of peers who exchange knowledge at a series of learning and discussion events.

If you are interested in attending a future Directors' Forum event, or nominating a participant, please contact your local Spencer Stuart office.

## C. Spencer Stuart offices worldwide

For a complete list of Spencer Stuart offices please visit www.spencerstuart.com/global-locations

## D. Spencer Stuart consultant contacts

To find a Spencer Stuart consultant specialising in board topics near you, please visit our website.

## E. Principal governance codes in Europe

**Austria**
Austrian Code of Corporate Governance (2015)

**Belgium**
The Belgian Code on Corporate Governance (2009, to be reviewed in 2017)

**Denmark**
Recommendations on Corporate Governance (2014)

**Finland**
Finnish Corporate Governance Code 2015 (2015)

**France**
AFEP-MEDEF Corporate governance code of listed corporations (2015)

**Germany**
Deutscher Corporate Governance Kodex (2015)

**Greece**
Hellenic Corporate Governance Code For Listed Companies (2013)

**Iceland**
Guidelines on Corporate Governance (2015)

**Ireland**
The Irish Corporate Governance Annex (addition to UK Corporate Governance Code) (2010)

**Italy**
Corporate Governance Code (2015)

**Netherlands**
Dutch Corporate Governance Code (2016)

**Norway**
The Norwegian Code of Practice for Corporate Governance (2014)

**Poland**
Best Practice for GPW Listed Companies (2016)

**Portugal**
CMVM Corporate Governance Code (2013)

**Spain**
Good Governance Code of Listed Companies (2015)

**Sweden**
The Swedish Corporate Governance Code (2015)

**Switzerland**
Swiss Code of Best Practice for Corporate Governance (2014)

**UK**
UK Corporate Governance Code (2016)

This is not an exhaustive list, but seeks to identify the principal code of corporate governance in each country. In addition, domestic law imposes obligations, listing rules of stock exchanges are relevant to many companies and institutional investors and their respective associations also issue their own guidelines and best practice. Coupled with national regulators and the European Commission's initiatives in this area, the field is crowded.

# About Spencer Stuart's Board Practice

At Spencer Stuart, we know how much leadership matters. We are trusted by organisations around the world to help them make the senior-level leadership decisions that have a lasting impact on their enterprises. Through our executive search, board and leadership advisory services, we help build and enhance high-performing teams for select clients, ranging from major multinationals to emerging companies to nonprofit institutions.

Privately held since 1956, we focus on delivering knowledge, insight and results though the collaborative efforts of a team of experts — now spanning 56 offices, 30 countries and more than 50 practice specialties. Boards and leaders consistently turn to Spencer Stuart to help address their evolving leadership needs in areas such as senior-level executive search, board recruitment, board effectiveness, succession planning, in-depth senior management assessment and many other facets of organisational effectiveness.

We have extensive experience conducting board assessments for a wide range of leading organisations throughout EMEA. Our consultants have deep knowledge of corporate governance laws, regulations and codes, as well as understanding the practices and behaviours that lead to true board effectiveness.

**For more information on Spencer Stuart, visit www.spencerstuart.com**

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