BOARDROOM BEHAVIOURS

A report prepared for Sir David Walker by the Institute of Chartered Secretaries and Administrators (‘ICSA’)
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ICSA Education and Research Foundation, registered charity no. 1027579, whose objects are to advance the education of the public in the law and practice of secretaryship and business administration by undertaking or assisting in the undertaking of research and the publication of the useful results of such research for the public benefit, has generously agreed to fund some of the consultancy costs ICSA has incurred in conducting this study and in producing a high-quality printed version of the report.
1 Executive summary

1.1 Since the onset of the financial crisis, and the economic slowdown which followed, a prominent question of policy makers, and market participants and observers, has been why some companies failed to foresee, and at least mitigate, the events which engulfed them. Attention has focused particularly on directors and boards, and apparent corporate governance failures, leading to a series of reviews covering financial regulation, banking governance and the operation of the Combined Code (the ‘Code’).

1.2 Although further regulation, particularly in the banking sector, appears inevitable, an emerging view is that the system of governance for companies is not inherently ‘broken’, but rather that its effectiveness has been undermined by a failure to observe appropriate boardroom behaviours.

1.3 In recognition of this, ICSA embarked on an analysis of boardroom behaviours, the outcome of which – as set out in this report – is being presented to Sir David Walker. At the same time a copy of this report is being sent to the Financial Reporting Council (‘FRC’).

1.4 This report concludes that:

• appropriate boardroom behaviours are an essential component of best practice corporate governance; and that the absence of guidance on appropriate boardroom behaviours represents a structural weakness in the current system;
• had that guidance been available and, more importantly, observed, some of the consequences of the current crisis might have been less severe and that, in any case, prevention of a recurrence of the events of the last year is at least partly dependent upon guidance on appropriate boardroom behaviours being incorporated in the Code; and
• better articulation of the business case for best practice corporate governance, and more focus on directors’ responsibilities and potential liabilities, should incentivise directors to exhibit appropriate boardroom behaviours.

1.5 To assist ICSA in developing the views set out in this report, it consulted a range of its own Members, and other members of the company secretary community. Expert views were gathered from colleagues and advisers operating in the boardrooms of major UK companies, including those from the FTSE100 and 250. A major contribution to the exercise came from company secretaries operating in the financial services sector, including some of the UK’s largest high-street banks, as well as representatives from other sectors including energy, defence, manufacturing, property and support services.

1.6 ICSA considers that the findings in this report have a wider relevance than ‘simply’ that of addressing the current crisis, and looks forward to working with interested parties to develop thinking, and best practice, on boardroom behaviours.
II  Observations

The consultation process generated the following observations:

2.1  Best practice boardroom behaviour may be characterised by:

- a clear understanding of the role of the board;
- the appropriate deployment of knowledge, skills, experience, and judgment;
- independent thinking;
- the questioning of assumptions and established orthodoxy;
- challenge which is constructive, confident, principled and proportionate;
- rigorous debate;
- a supportive decision-making environment;
- a common vision; and
- the achievement of closure on individual items of board business.

2.2  The degree to which these behaviours can be delivered is shaped by a number of key factors:

- the character and personality of the directors and the dynamics of their interactions;
- the balance in the relationship between the key players, especially the chair and the CEO, the CEO and the board as a whole, and between executive and non-executive directors;
- the environment within which board meetings take place; and
- the culture of the boardroom and, more widely, of the company.

2.3  Despite the importance of these and other considerations, it is remarkable that there is practically no guidance in the Code on the main drivers of, and factors affecting, boardroom behaviours. While ICSA considers it may be undesirable, even unhelpful, to prescribe appropriate behaviours by legislative provision, supported by penal or regulatory sanctions, ICSA nevertheless considers it is possible to formulate guidelines on the behaviours to be expected of directors when discharging their duties to the company. ‘Getting the best out of the board;’ and encouraging best practice boardroom behaviours, are critical aspects of corporate governance, but seem currently to be a neglected area.

2.4  Notwithstanding the furore surrounding the collapse, or near collapse, of a number of companies, there should be a recognition that directors are generally well-intentioned, and are motivated to do well for their companies. It should also be acknowledged that directors have made significant progress in strengthening the governance frameworks within their companies on the basis of existing guidance.

2.5  To improve on existing standards of behaviour in the boardroom, directors need to develop a greater awareness of, and commitment to, ‘fit for purpose’ governance as the means by which the board can collectively agree the business objectives of the company and a strategy for their implementation by executive management.

2.6  Heightening directors’ sensitivity to the importance of the need for further change can be achieved by acknowledging and developing the motivations for improved performance. The two principal drivers are:

- ‘Benefit’ – helping directors to see best practice corporate governance as a business facilitator and not a business killer. The value proposition of best practice governance should be framed in terms of the aim to maintain and grow the legitimacy, credibility and capability of the company to deliver the business plan and strategy. The pursuit of best practice corporate governance should be seen as delivering competitive advantage, because it strengthens the process and quality of decision-making and, hence, the overall efficiency and effectiveness of the board and, ultimately, the company.
• ‘Failure’ – reminding directors how failure to perform at a satisfactory level can carry negative consequences. Behavioural change will also be driven by taking account of directors’ duties, responsibilities and potential liabilities. Directors need consciously to reflect on a wider range of considerations than those simply related to short-term profit and share-price growth. Greater awareness of the non-financial factors which deliver the sustainability of the business model, and take account of the legitimate expectations of shareholders and other business-critical stakeholders, is crucial in helping the company achieve its business objectives. The duty to promote the success of the company plays a key role here. Section 172 of the Companies Act 2006 states:

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

(a) the likely consequences of any decision in the long term,
(b) the interests of the company’s employees,
(c) the need to foster the company’s business relationships with suppliers, customers and others,
(d) the impact of the company’s operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct, and
(f) the need to act fairly as between members of the company.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

2.7 Ultimately, issues of risk to reputation underlie both drivers. Strong standards of performance in terms of boardroom behaviour should bolster directors’ reputations. In contrast, the current financial crisis has confirmed the irreparable damage that has been done to some directors’ reputations as a result of being perceived as responsible for some of the recent corporate failures.

2.8 The reputations of other boards of directors have suffered as remuneration committees have exercised discretion by awarding bonuses in circumstances where executive directors have not met agreed performance targets, leading to well-publicised and damaging shareholder disapproval of boards’ remuneration reports. There is growing public interest in what boards do and how they are governed, but there remains a mismatch between the attitudes and expectations of executive directors, the approach taken to reward issues by remuneration committees, and the prevailing mood of shareholders and the ultimate stakeholder body, the public at large.

2.9 Improvements in behavioural practice will also be built on a deeper understanding of the relevance of and emphasis on, culture, vision and values – informed, in turn, by greater commitment to the importance of the relationship between issues of transparency, accountability, disclosure, trust and confidence. These are business-critical areas as much for boards operating in steady state as for those managing a crisis, contemplating strategic change, or pursuing due diligence in relation to a proposed acquisition or other aspect of corporate activity.

2.10 All directors – including executives – should seek to improve their performance in these important areas. They should bridge the ‘knowledge gap’, with corresponding personal development and learning opportunities focused on the fundamentals of good corporate governance as determined by directors’ duties, related to the specific business model, strategy and operations of the company.
2.11 The process for helping non-executive directors deepen their knowledge of the business to a level that optimises their understanding, and allows them to challenge proposals constructively, can be made more effective by allowing them greater exposure to the company’s operations. ICSA submits that there should be a general presumption towards unhindered access by directors to information and staff in key areas of the business.

2.12 Knowledge is also a function of board balance. The trend towards a decrease in the numbers of executives attending board meetings may be detrimental. The Code’s requirement (other than for small companies) for a majority of independent non-executive directors has led to a reduction in the number of executive directors, sometimes to just two – the CEO and the CFO – in order not to increase board size. This has, unintentionally, led to a situation of information flow through two or sometimes three executive directors who, with the best will in the world, will be unable to master the whole corpus of the company’s objectives and operations. Periodic appearances by senior operational executives may not be sufficient to address this potential structural weakness. It might therefore be necessary for some organisations to review this balance of executive and non-executive directors.

2.13 Diversity of board membership is necessary to provide for the kind of independent challenge which the current financial crisis suggests may have been useful on the boards of some companies that encountered difficulties. It is evident that boards do not currently contain a sufficiently wide range of skill sets, experience and background – including those recruited from academia, the public and not-for-profit sectors.

2.14 High standards of rigorous and, occasionally, independent evaluation are needed to increase boards’ effectiveness. Generally, further emphasis should be placed on the means for ensuring accountability in the areas of individual director and whole board performance.

2.15 Directors should be assessed, inter alia, against expectations relating to boardroom performance and behaviours and, where appropriate, their remuneration arrangements should reflect those aspects. At the moment many executive directors appear to face a potential conflict because they are remunerated on the basis of the way in which they manage the business to maximise short-term value rather than pursuing the goal of a sustainable business model. Generally, these remuneration arrangements seem to place little emphasis on their behaviours as directors in the boardroom working on behalf of shareholders’ long-term interests.

2.16 In terms of developing a wider perspective, boards should show more clearly, not least in their work of supervising risk management and devising the company’s risk appetite, that they are looking forward and out, as well as backwards and in, including by their use of lead rather than simply lag KPIs.

2.17 The board should exercise compelling and relentless leadership and should not underestimate the power of leading by example – evidenced by high levels of visibility and integrity, strong communications, and demanding expectations. This leadership should be clear to all within the organisation, as well as shareholders and other external stakeholders.

2.18 The board should consciously and formally agree its behavioural objectives so as to act as a unified body, irrespective of the nature of the tenure of individual members, and to drive board process through a uniting set of behaviours.

2.19 Mechanistic issues – such as the timeliness of circulation of board papers – can have a disproportionate effect on the quality of decision-making. Other organisational features of board activity – including away days, and changes to the ‘established way of doing things’ – may help inject new perspectives into practices which have become too conventional.

2.20 The company secretary has a key role to play in helping boards perform even better. In summary, the role should become that of the chair’s chief of staff, or chef de cabinet, in helping to assure delivery of a well-functioning board.
III Conclusions

3.1 General conclusions

3.1.1 ICSA considers that weaknesses in the application of governance processes lie at the heart of some of the cases of corporate collapse and near collapse. Although the Code may not be ‘broken’, at least four uncomfortable truths have emerged:

- well-run companies were capable of making strategic, sometimes catastrophic, misjudgments;
- risk management was not properly overseen, monitored and reviewed at board level and boards were not addressing and discussing the company’s risk appetite;
- remuneration and incentivisation were not aligned with shareholders’ objectives; and
- disclosure failed to inform stakeholders sufficiently.

3.1.2 ICSA considers that analysis of these failures requires a response at three levels:

- Institutional – are the corporate governance policies and architecture fit-for-purpose?
- Organisational – has management installed adequate processes and systems?
- Behavioural – are directors exhibiting the appropriate behaviours?

3.1.3 The required institutional and organisational responses are being handled by the scope of the Walker and FRC reviews. As agreed, therefore, ICSA’s response to the Walker review focuses on the behavioural aspects of board performance during the financial crisis, and the way in which boards behave more generally, irrespective of sector and economic circumstances.

3.2 Specific conclusions relating to boardroom behaviours

3.2.1 The evidence collected during ICSA’s consultation exercise suggests that, behaviourally, some boards have been performing to what might normally have been considered reasonably high standards. The nature and scale of the value destruction, however, confirms that existing standards were inadequate, and that a more robust approach to corporate governance behaviours is necessary. Moreover, the links between boardroom behaviours and the institutional and organisational corporate governance issues which have still to be addressed as part of the Walker and FRC reviews, confirms that governance behaviours cannot be viewed in isolation.

3.2.2 As matters stand, the absence of guidance on appropriate boardroom behaviours represents a structural weakness in the current system. Further improvements in performance on behaviours are necessary, and it is possible that, had some of the guidance suggested in this submission already been in place, and observed, some of the subsequent failures in corporate governance would have been less pronounced, and their consequences less severe. In any case, prevention of a recurrence of the events of the last year is at least partly dependent upon more robust guidance on boardroom behaviours being incorporated in the Code.

3.2.3 As part of its approach in devising practical solutions to the current challenges, ICSA is willing to prepare a best practice guidance note on how boards can create the circumstances for improved boardroom behaviours. Nevertheless, ICSA is firmly of the view that such a guidance note will not inject the necessary levels of urgency and obligation unless the Code is also amended.
3.2.4 ICSA considers that:

- the case has still not been sufficiently articulated for the values and benefits which flow from good corporate governance and, therefore, the business case for encouraging directors to pursue best practice with enthusiasm and genuine commitment;
- better articulation of the business case for best practice corporate governance is likely to incentivise directors to exhibit appropriate boardroom behaviours more rigorously and more readily;
- despite the foregoing, it is also reasonable to assume that some directors are incentivised more, or at least as much, by fear of the consequences of things going wrong; and
- in these circumstances, more focus on directors’ duties, responsibilities and potential liabilities, is likely to generate a heightened awareness of the need to exhibit appropriate boardroom behaviours more rigorously and more readily.
IV Recommendations

4.1 From these conclusions, ICSA considers it appropriate to **recommend** that, to provide the necessary obligation and focus, the Code should be amended to incorporate wording or references relating to:

- appropriate boardroom behaviours;
- the business case for pursuing best practice corporate governance;
- directors’ duties under the Companies Act 2006: particularly s172, the duty to promote the success of the company; and
- an accompanying best practice guidance note on how boards can create the circumstances for improved boardroom behaviours.

4.2 These recommendations fall short of calling for a more formal requirement for boardroom behaviours to be prescribed, or for there to be oversight of the implementation of the new/existing provisions by the Financial Reporting Review Panel or the FSA.

4.3 Some of the observations in this report relate more directly to the work of the Walker and FRC reviews, and require responses from those reviews if they are to be given proper context. The links between boardroom behaviours and institutional and organisational aspects of boardroom governance mean that the recommendations made by ICSA may need to be accompanied by additional Code changes if they are to have full effect.

4.4 The FRC should consider whether it would be appropriate to endorse a best practice guidance note as part of the FRC assuming an enhanced leadership role in defining the characteristics of a well performing board, so as to encourage behaviours in the boardroom that enable companies to attain and maintain these appropriate standards of boardroom behaviour. The FRC may wish to consider whether a best practice guide should form an appendix to the Code.
Appendix A

Background
On 9 February 2009, the Chancellor of the Exchequer, the Secretary of State for Business, Enterprise and Regulatory Reform and the Financial Services Secretary to the Treasury announced a review to recommend measures for improving the corporate governance of UK banks, particularly in terms of risk management. The review is being chaired by the former financial services regulator, Sir David Walker.

Scope of review
The review will examine board management of risk (including the effectiveness of risk and audit committees), incentives to manage risk in bank remuneration policies, the competences needed on bank boards, board practices and structures, and the role played by institutional shareholders. The review will present preliminary conclusions to commissioning Ministers in the autumn, and make final recommendations by the end of the year.

In launching the review, the Chancellor of the Exchequer said that ‘... it is clear that corporate governance should have been far more effective in holding bank executives to account.’ The Business Secretary stated that the review was needed to ensure that ‘...we have competent, well-run and transparent boards, which are engaged with their shareholders, and capable of understanding and managing risk effectively.’ Finally, the Financial Services Secretary pointed out that the issue was not simply one for the boards themselves – ‘Boards are effective only when held to account by vigorous and alert owners who devote the time and effort needed for engagement.’

ICSA's response to the Walker Review
Following a meeting with Treasury officials on 12 March, it was agreed that ICSA would contribute to the review by conducting research on ‘appropriate boardroom behaviours.’ The basis for this work was the position ICSA had adopted in relation to corporate governance issues, particularly through the ICSA Hermes Transparency in Governance Awards, its specific expertise as ‘owners’ of boardroom process, the special privilege enjoyed by many of its Members in terms of boardroom access, and the professional qualities of its Members in terms of independence and integrity.

Review of the Combined Code
The chair of the Financial Reporting Council (FRC), Sir Christopher Hogg, announced at ICSA’s Corporate Governance Conference on 18 March that it intended to review the operation of the Code. Given the relevance of ICSA’s work, it was agreed that the outputs from ICSA’s research for the Walker Review would be shared with the FRC.

Consultation process
ICSA is the professional body that qualifies Chartered Secretaries. Many of our Members are company secretaries in public listed companies and take responsibility for ensuring that the Code is embedded in the governance structure of the company, and that appropriate disclosures are made about corporate governance to the companies’ shareholders, usually through the annual report. Their presence in the boardroom, and their direct relationship with the chairman, give company secretaries a clear perspective on the effectiveness or otherwise of the Code in encouraging the most suitable governance framework for their particular companies.

ICSA considers the current exercise an important opportunity to contribute practical ideas to the Walker and FRC reviews on any changes needed to restore the perception, and reality, of UK companies as well-run, value-creating and accountable.
Process
ICSA devised a questionnaire (see Appendix B) seeking the views of members of the company secretary community on a number of boardroom governance-behaviour issues. The questionnaire was pre-tested with a representative range of Members, and circulated widely, including in ICSA’s magazine, Chartered Secretary, and on ICSA’s website, as well as to the company secretaries of the FTSE350 directly.

The questionnaire was used as the framework for discussion at a series of workshops hosted by ICSA at its headquarters in London on 11 May 2009, with a good representation from both FTSE100 companies and those from the wider company secretary community, and conducted under Chatham House rules. ICSA considers the views presented in the exercise represent an authoritative perspective on the current state of boardroom behaviours inside larger UK companies.
Appendix B
Boardroom behaviours – questionnaire

Questions
1. To what degree do you believe your board, and its directors, are responsible for defining the culture and behaviours of the organisation? Is this an essential part of ensuring the business’s long-term sustainability?

2. Do you believe more work is needed to ensure that the appropriate organisational culture is observed, and the company’s specific values exhibited, by directors when making board-level decisions? If so, how?

3. Do directors feel encouraged, or inhibited, in displaying the necessary behaviours in the boardroom to enable them to challenge, independently, the views of colleagues? Please give examples?

4. Do you believe a different approach to governance behaviours or other processes in the boardroom could have changed the way in which decisions were taken in relation to recent well-documented cases of value destruction and (near) corporate collapse? If yes, how?

5. How does the Combined Code play a role in encouraging the appropriate boardroom behaviours to deliver high-standard governance? If it does not, what recommendations would you make for improving boardroom governance behaviour through the Combined Code mechanism?

6. In terms of strengthening governance behaviours, is there a greater role for induction, continued professional development and assessment in improving the knowledge, skills, experience, judgement and independence of directors?

7. Assuming that transparency facilitates accountability, and creates the conditions for engendering trust, would greater disclosure on boardroom process – including in the annual report – facilitate or hinder desired changes in boardroom behaviour?

8. Which provides the greater incentive for directors to consider the importance of boardroom behaviours – the risk of ‘punishment’ (e.g. under the directors’ duties provisions) or the reward of ‘recognition’ (e.g. through remuneration)?

9. To what degree is the chair the person whose behaviour most needs to change if the behaviour of the board as a whole is to change?

10. Which specific aspects of board process – including time pressures and the timeliness of circulation of papers – most militate against high-quality decision-making by boards?

11. What steps might be taken to encourage boards to understand that they are ‘one step down’ from the owners, rather than ‘one step up’ from executive management?

12. How might institutional investors play a role in changing boardroom behaviours?

13. Do you feel that the annual evaluation of the board and its committees is genuinely formal and rigorous and that areas for improvement are followed up in a consistent way?

14. As regards risk management, do you feel that your board is invited to review the right subjects and is provided with the necessary information?
Appendix C

The Institute of Chartered Secretaries and Administrators (ICSA) is the professional body for Chartered Secretaries. ICSA’s Royal Charter was granted on 4 November 1902, eleven years after ICSA was founded in 1891. Under the Charter, the Institute has as its objective ‘the promotion and advancement of the efficient administration of commerce, industry and public affairs’.

Chartered Secretaries work as company secretaries (some of them for the leading public companies in Britain), share registrars, charity secretaries, senior managers, sometimes as board directors, and in many other roles at the senior administrative or operational level in the private, public and not-for-profit sectors of the economy. In large companies the role of the company secretary (many of whom are Chartered Secretaries qualified by ICSA) encompasses a considerable number of responsibilities that collectively facilitate the efficient running of the board and the organisation and its compliance with all applicable law and regulation, and best practice in corporate governance.

ICSA:

- qualifies Chartered Secretaries through its qualifying schemes;
- sets and maintains standards of behaviour and competence;
- enforces a strict code of conduct with which all Chartered Secretaries are required to comply;
- supports the private, public and not-for-profit sector with professional resources;
- works with its Members and governmental and other statutory bodies to promote best practice and provides guidance on good governance;
- promotes the importance of good corporate governance and the value of Chartered Secretaries to employers, and consults its Membership on relevant proposed legislative change; and
- publishes guidance notes and best practice guides and through its subsidiaries provides events, information and training, boardroom evaluation and dedicated software.

ICSA has 36,000 Members and 27,000 students in over 70 countries. ICSA’s headquarters are in London with separate operating divisions in the UK and Republic of Ireland, Australia, Canada, Hong Kong, Malaysia, New Zealand, Singapore, South Africa and Zimbabwe. As a global professional body, ICSA is uniquely placed to comment on training, regulatory and business issues.

The professional standing of Chartered Secretaries is strengthened, in no small part, by their recognition in statutory provisions. For example, Section 275 of the Companies Act 2006 states that Members of ICSA are recognised as qualified to hold the role of Company Secretary in public companies, alongside members of other professions such as accountants and solicitors. Section 43 (2), (3) and (4) of the Charities Act 1993 as amended by Statutory Instruments 2008 No. 527 states that Chartered Secretaries can, in addition to accountants, act as independent examiners for the annual audit of charity accounts. Statutory provisions recognise the role of Chartered Secretaries as Members of a professional body, ICSA.