

THE IMPACT OF DIVERSITY AND INDEPENDENCE ON BOARD EFFECTIVENESS

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Introduction: EuropeanPWN 2004 Survey

As a starting point for my remarks, I want to refer to the study that we undertook in conjunction with the European Professional Women's Network almost 12 months ago. The purpose of this study was to look at two of the more obvious signs of diversity on the Boards of Europe's largest companies. More specifically, we looked at:

- the number of the female Board members and,
- the number of directors who are not nationals of the country where the company is headquartered.

Focussing on the top 200 industrial companies in Europe plus the 20 largest banks and the 20 largest insurance companies, we drew together information from 14 European nations.

What we discovered was that:

- 8% of the Board members were women,
- 62% of the companies in the survey had at least one woman on their Board
- but, that only 28 % of companies had more than one woman on the Board.
- While the percentage of women on Boards varied significantly from country to country, (Italy 2%, Norway 22% and France 6%) the European picture was certainly less positive (at 8%) than is the case in North America where in the USA the figure is 14% female board members.
- Similarly, the number of international Directors also varied substantially from one country or industry to the next but it was in general terms relatively low at 23%, and only 18% in France.

That there are any women at all on the Boards we studied is probably the result of efforts of organisations such as yours and its predecessors and their impact on public opinion, some enlightened chairmen and/or nomination committees and also because of the revised codes of corporate governance, which have been introduced in most countries and internationally in recent years.

Governance codes:

Since May 1999 when the OECD released its first "Principles of Corporate Governance" which it subsequently revised in May 2004, more than 40 codes or sets of principles have been introduced in the OECD area alone. This includes Vienot II (July 1999) and the Bouton Report (Sept 2002) in France or the Combined Code (July 2003) in the UK for example. The typical form of these codes has been a mix of legal and regulatory instruments and voluntary approaches frequently backed by an obligation to comply or explain, or at the very least to disclose.

The corporate governance codes of the early 2000s were introduced by governments and regulators in response to the business failures of the late 20th century. These failures were due, as is typically the case historically, to bad business plans, poor managerial decisions and outright fraud. Their impact on society was, however, greater than in the past given the size of some of the failures such as Worldcom, Enron, Ahold etc., their coincidence with the bursting of the dot-com bubble, and because personal and corporate pension funds now have a significant part of their assets invested in equities.

Corporate governance, in very broad terms, is the system by which companies are directed and controlled and a code of expectations and conduct is needed if only because of the separation under the capitalist system of ownership, monitoring and control.

The changed or new corporate governance codes have broadly focussed on issues related to disclosure and transparency in financial reporting and risk management and on questions to do with Board composition and duties including limiting or eliminating conflicts of interest. Additionally they have sought to introduce better financial and accounting standards and improve auditor independence and external oversight. They have also focussed on shareholder rights including the equitable treatment of all shareholders, and the positions of other stakeholders are now much more clearly on the agenda.

Despite all the national differences, the new and revised codes have common features. For example, they emphasise that the Board must supervise management and that the quality of directors needs to be improved. They also look at ways of improving accountability to shareholders and how better corporate governance and Board intervention can improve company performance and improve their access to capital. The codes typically suggest that the key determinants of an effective Board are the number of independent or outside Directors, the process leading to the nomination at the selection of new Board members, separation of the roles of Chairman and Chief Executive, Board size, the creation of specific Board Committee such as audit and remuneration and so on.

As a consequence of the codes, and sometimes as directed by the codes, Boards have sought to broaden the pool of individuals from whom they select board members. Increasingly they are using the services of the executive search firms to assist in this

endeavour, and the opportunities for women directors have gradually but substantially increased.

The "old boys network" has effectively been badly damaged if not destroyed by the code requirements.

Governance codes and Board effectiveness

However, the evidence linking the structure or composition factors to improved company performance is at best questionable and the cost of compliance particularly to the US required Sarbanes-Oxley, SEC and NYSE requirements is particularly high. Given that the evidence linking issues of composition and structure to performance is so scant - is this evolution sustainable?

And another point: you have all seen the studies, particularly from US, linking the performance of companies with female Board members and returns on investment etc. While many of these studies do not seek to make a causal link between these two factors, the implication of what they have tried to say is very clear. Put very simply, put more women on the Board and the company performance will improve.

My own view is that better managed companies will tend to have better managed and structured Boards with better people on them and that to isolate one issue, e.g., "females on boards" and link it with company performance is a very tenuous piece of logic.

Board effectiveness

Interestingly, the developers of the codes of good governance concur with the view that the structures and processes that they recommended do not really lead to more effective Boards. For example, Derek Higgs, the key reformer in the UK, states that, “effective Boards depend on the best people and on their behaviours and relationships” and Alain Bouton suggests that, “although procedural rules and recommendations concerning the operation of the Board and its committees are essential corporate governance standards, any procedure will only be as good as the people implementing it.”

In essence, they are implying that **there is a difference between satisfactory corporate governance and board effectiveness.**

At Egon Zehnder International, we have been advising Boards of Directors on issues related to Board membership and more recently on Board performance and effectiveness for well over a decade. Perhaps, not surprisingly, given the nature of our profession we are strong believers in the view that it is the quality of people and how they interact rather than how they are classified or arranged which determines whether a Board will be effective or not.

Much work has been undertaken in recent times in order to determine what really makes a Board effective. I have quoted both Higgs and Bouton. A noted US academic, Jeffrey Sonnenfeld says that “It is not rules and regulations. It is the way people work together that makes a board great.” He argues that there is a strong link between Board process and effectiveness and suggest that an effective Board engages in constructive conflict but avoids destructive conflict, works together as a team, knows the appropriate level of strategic involvement and addresses decisions comprehensively.

Another leading academic, Canadian Richard Leblanc similarly contends that Board effectiveness is linked to the independence of judgement, competencies and behaviours of the Chairman of the Board; the behavioural posture of the CEO within the boardroom or his/her relationships with the boards; and the effectiveness of individual Directors including their independence of mind, competencies and behaviours.

Based on our experience undertaking Board reviews, we believe that an effective Board is the result of choosing the right group of people and having them effectively led.

Diversity & Independence

I would now like to return to the two initial concepts of diversity and independence.

Unfortunately, I think that both these words and their place in the debate on good corporate governance and Board effectiveness has been shrouded in semantics.

When we think of diversity, we immediately think of gender, nationality or ethnic backgrounds. I suggest this is because they are the most obvious forms of diversity. However, it can easily be argued that someone who has a background career as a functional specialist as opposed to someone whose career developed as a General Manager will have a different view of the world and thus diverse opinions will be represented.

Similarly, most of the governance codes go out of their way to endeavour to define what independence means. Through elaborate definitions, members of the family of current employees or past employees, significant shareholders, etc. are deemed to lack independence on the grounds that they may or will have conflicts of interest. On the other hand if one thinks of true independence, it is really a state of mind: the ability to think independently and express the views that result from this thinking.

Wisdom of Crowds

As I struggled with these concepts and their meaning sometime in the middle part of the last year, I came across an excellent book published in the US by a staff writer for "The New Yorker". His name is James Surowiecki and the book is called "The Wisdom of Crowds."

As the "blurb" says, "In this endlessly fascinating book, Surowiecki explores a deceptively simple idea that has profound implications: large groups of people are smarter than an elite few, no matter how brilliant—better at solving problems, fostering innovation, coming to wise decisions, even predicting the future."

In the book, the passage that struck me as most relevant in the context of Boards was the following:

"Diversity and independence are important because the best collective decisions are the product of disagreement and contest, not consensus or compromise. An intelligent group does not ask its members to modify their positions in order to let the group reach a decision every one can be happy with. Instead, they figure out how to use mechanisms to aggregate and produce collective judgements to represent not what any one person in the group thinks but rather in some sense what they all think. Paradoxically, the best way for a group to be smart is for each person in it to think and act as independently as possible."

Surowiecki then goes on to define the four conditions that categorise what he calls "wise crowds" and which therefore need to be understood in the context of an effectively functioning Board of Directors. They are:

- Diversity of opinion: Each person should have some private information even if it is just an eccentric interpretation of the known facts. Diversity adds perspectives that would otherwise be absent and importantly, it weakens some of the destructive characteristics of group decision making. Groups that are too much alike find it harder to keep learning because each member is bringing less new information to the table.
- Independence: Peoples' opinions are not determined by the attitude of those around them. Independence is important to intelligent decision making because it keeps the mistakes people make from being correlated; i.e. it keeps them less dependent on each other for information. Independent individuals are also more likely to have new information rather than the same old data everyone is familiar with.
- Decentralisation: People are able to specialize and draw on "local knowledge". There are two key characteristics about decentralisation that matter in this context. Firstly, it fosters and is fed by specialization. Specialization tends to make people more productive and efficient and it increases the scope and diversity of the opinions in the system. Secondly, if a person is closer to the problem the more likely he or she to have a good solution.
- Aggregation: Some mechanism must exist for turning private judgements into a collective decision. The process of the Board meeting allows for the aggregation of diverse, independent and decentralized perspectives if the meeting is well chaired.

Conclusion

So let me now try to bring the threads together.

Based on the multitude of discussions that our consultants have with Chairmen, with directors and with senior executives we are convinced that corporate governance will remain on the agenda for many years to come. But compliance with the new codes will not be the big issue in the future. Pressure due to listing rules, legislation, investor or public opinion and the like will ensure that “comply or explain” will take hold.

However, if you acknowledge that it has now been established that in the last five years more shareholder value has been destroyed as a result of the strategic mismanagement and poor execution than was lost in all the recent scandals, then within or despite the rules, Boards will be seeking to increase their effectiveness and their ability to monitor and support management.

Chairmen together with nominating committees, if not the board as a whole, must define the governance approaches and style that they wish to adopt. A complex mix of Contexts (governance, strategic and operational), Roles (of the board v management and of the board team) and Relationships (with management and within the boardroom) must be agreed upon. Directors can then be chosen against this background and for their potential contributions as individuals and team members based on the competencies and experience required. Board members who have diverse backgrounds thus ensuring balance and accountability exist around the Board table will be chosen and the performance of the Board as well as its role, style and membership will be reviewed regularly.

Role of the Non-executive Director

The crucial role of any Non-executive Director, male or female, is to create accountability within the executive team. For this to occur, Non-Executive Directors or external Board members must be capable of challenging, questioning, testing, probing, debating, advising and informing. For executives to take the Board seriously and thus to have effective accountability, the value of Non-Executive Director contributions needs to be recognised. To hold the executives to account, Non-Executive Directors need to have relevant experience gained elsewhere, an adequate knowledge of the particular Board on which they are serving and of the directors they are interacting with, and of the company or business for which the Board is responsible. Failure to acquire such an understanding of the company is likely to weaken the credibility and the perceived value of the Non-Executive Directors' contribution.

Effective Non-Executive Directors must have the will and the skill to generalise some of their experience and the ability to transfer their knowledge on particular issues to another organisation. They must be engaged but non-executive, they must both challenge and support, and they must demonstrate both independence as well as involvement.

To do this we would argue that all Board members need four basic competencies. In other words, they need the knowledge and experience that allow them to demonstrate

results orientation, strategic orientation and at the same time be both independent and collaborative.

Thus, the basis for a woman to be a successful Director is the same as it is for a male. The career, which a woman has had as an executive and the exposure that has been gained along the way must be relevant to the task at hand. Thus to me at least, the idea of searching out potential Directors in an extremely lateral way is one containing very high chance of risk. Relevant experience is the key.

However, if one accepts the arguments on the value of real diversity and independence then women are streets ahead of their male counterparts. It is my firm belief that the opportunities available to you will increase substantially as we move from compliance to performance, a trend that I see as inevitable going forward.