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Directorate General Internal Market and Services /Company Law
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Dear Sir

GREEN PAPER: THE EU CORPORATE GOVERNANCE FRAMEWORK Consultation Response to Question 8

Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?

Introduction Boardroom Review was founded in 2004 by Dr Tracy Long to give independent and informed advice on the effectiveness of the board and its committees, and to offer an external evaluation process which is flexible and engaging, forward looking, and unbureaucratic. Boardroom Review is a leader in the field of evaluation, and has conducted 60 evaluations with over 46 organisations over the last six years; clients include FTSE 100 and 250 companies, membership and mutual organisations, government agencies and charities. Please see Boardroom Review's website for further information.

Boardroom Review welcomes the opportunity to respond to the consultation on the EU Corporate Governance Framework, and would be delighted to support the European Commission as it develops its approach to external board evaluation. This document is in response to Question 8 "should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?". This document is on record and may be freely quoted or reproduced with appropriate acknowledgement¹.

Background The views of UK regulators regarding board evaluation have changed significantly over the last eight years. From Sir Derek Higgs' gentle suggestion in 2003², first outlined in the Combined Code on Corporate Governance - "the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors" - the guidance was developed by Sir David Walker in the Walker Report³ in 2009 - "the board should undertake a formal and rigorous evaluation of its performance, and that of committees of the board, with external facilitation of the process every second or third year". This has most recently resulted in the provisions outlined by the UK Corporate Governance Code⁴ in 2010 - "the board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years. A statement should be made available of whether an external facilitator has any other connection with the company" - and the FRC's Guidance on Board Effectiveness⁵ in 2011.

It is worth noting that long before the UK regulators had decided to recommend a three year external evaluation for listed companies, the market had already determined this interval for itself. Formally introduced in 2003 as a process which should add value to the way in which chairmen considered and improved the board's performance and effectiveness, the regulators did not at the time recommend any particular methodology; it is, therefore, a significant change to suggest that every two or three years the board should use an external reviewer to conduct a board evaluation. Not surprisingly, this has created uncertainty in the UK marketplace; board evaluation is a relatively new discipline, there are very few experienced reviewers, and many chairmen⁶ and directors are unfamiliar with the advantages and disadvantages associated with different approaches.

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² See HIGGS, D. (2003) Review of the Role and Effectiveness of Non-Executive Directors. London, DTI.

³ See WALKER, D. (2009) A review of corporate governance in UK banks and other financial industry entities. HM Treasury.

⁴ See FINANCIAL REPORTING COUNCIL (2010) UK Corporate Governance Code. London.

⁵ See FINANCIAL REPORTING COUNCIL (2011) Guidance on Board Effectiveness. London.

⁶ The terms chairman and chairmen appear in this paper as a role description, rather than an indication of gender.

The Importance of External Board Evaluation A well conducted external board evaluation encourages directors to step back from the day-to-day business of the board, providing them with a rare but legitimised opportunity to 1) question board approach and expectation, 2) objectively interpret the board's impact and contribution to the long term health and success of the company, and 3) unite and prepare themselves for the challenges ahead. The process is intended to provide an opportunity for the board to recognise and reflect the current and future needs of the company, and offer an important catalyst for discussion and change.

Clearly this is not a compliance function; the effectiveness of the board is influenced by a combination of interactions and processes that are dynamic by nature, and which are difficult to assess. There can be no template; the role of the board, and its issues, are complex, and directors are intellectually demanding, occasionally defensive and often sceptical. The evolution of the board's approach and modus operandi will have been influenced by, inter alia, changes in the company's lifecycle and the impact of history, its external landscape and the speed of change, corporate structure, and board composition, culture and process. Engaging an external reviewer is a critical decision; the ability to gather and analyse reliable evidence, to communicate difficult messages in a constructive way, to have a level of comfort and familiarity within a boardroom environment, and to foster strong and trusting relationships whilst remaining independent, is an uncommon combination of skills. The impact of an evaluation, which has investigated a broad range of influences and identified strengths and weaknesses, can be significant, either enhancing a board's performance and effectiveness or, if badly conducted, damaging its confidence and cohesiveness. In order to add considerable value, therefore, an evaluation demands maturity and courage from the board, wisdom and skill from the reviewer, and integrity and legitimacy from the process.

There are several benefits:

- 1) an honest examination of the board's ability to achieve its objectives allows directors to question their approach to, inter alia, the development of strategy, the oversight of risk and control, the management of performance, leadership and succession, and the consideration of shareholder and stakeholder views. It provides an opportunity to explore the positive and negative influences of the board's culture and dynamics, the quality of its debate, the contribution of individuals and the board as a whole, the impact of leadership roles such as the chairman, senior independent, committee chairmen and CEO, and the board's size and composition. It also encourages an assessment of the board's processes, its calendar and agendas throughout the year, the quality of board and committee information, and the strength of its secretariat support.
- 2) a well conducted interview process is an effective and flexible methodology which can produce high quality, well considered evidence. A thoughtful and relevant interview, which is conducted within a confidential forum, encourages directors to talk openly about issues and concerns on an anonymous basis, to consider answers to questions that may not have been posed by the chairman, colleagues or shareholders, and to continue the development of themes after the interview, and often the evaluation itself, has finished. The intimacy of such an interview, and the benefits thereof, depend on the confidence in, and the confidentiality of, the reviewer, but provide a unique opportunity to discuss the performance of the board, its culture and dynamics, and the use of its time.
- 3) depending on the approach taken, the findings and recommendations from an evaluation can relate to a variety of influences on the board's effectiveness, and can be articulated in a number of ways; through written documents, board presentations, individual meetings, collective discussions, and workshops. This presents several diverse opportunities for constructive criticism and objective debate, including collective discussions with the whole board, and sensitive feedback to individual directors.
- 4) an experienced reviewer can add valuable context and judgment within both the written work and in discussion with the board. An objective and knowledgeable view, rather than a simple regurgitation of data, can add significant long term value to the board through high quality analysis, appropriate contextualisation and constructive criticism, a meaningful identification and separation of perception and reality, and the provision of relevant recommendations. The reviewer, for a brief period of time, can become a critical friend to the board, investigating and challenging sensitive and confidential issues with only the board's best interests, and its contribution to the company's success, on the agenda.

The Development of External Board Evaluation in the UK The development of effective external evaluation is critical to the ongoing effort to understand and improve board performance; board effectiveness, as Higgs suggested in 2003, requires “a culture of openness and constructive dialogue in an environment of trust and mutual respect”. As boards of directors are unique in their architecture and objectives, the template and checklist approach to evaluation, developed with expediency and compliance in mind, appears increasingly inappropriate and blunt, insensitive to the efficiency and effectiveness demanded of the modern boardroom, and incapable of measuring and adding value within a complex and discrete environment.

In the UK there are now a number of different evaluation approaches, which vary from the sole use of an online questionnaire, to an in-depth psychoanalytical assessment. The approach taken will partly depend on why the evaluation is taking place – to be compliant, to respond to external pressure, to benchmark the board’s performance, to facilitate change, or to enhance the board’s long term effectiveness. It will also influence a number of important choices, including:

- 1) the way in which the reviewer interacts with the board before, during and after the evaluation;
- 2) the disclosure of board papers and related documents;
- 3) the number of participants, and the time they will need to invest in the evaluation;
- 4) whether the board and its committees are observed;
- 5) the time taken to complete the evaluation, and its planning within the board calendar;
- 6) the way in which the findings are communicated to the board collectively and individually;
- 7) the cost of the review;
- 8) the nature of disclosure within the annual report, and to shareholders and stakeholders;
- 9) the longevity of the value and impact of the review.

Given that the performance of the board is ultimately the chairman’s responsibility, it is important that he or she has the right to choose, in consultation with colleagues, the appropriate methodology for the board, and has the opportunity to assess the skill, experience and chemistry of the reviewer. Reviewers will have different interpretations of their role, the way in which they conduct the evaluation, what topics will be covered, and what questions asked. Some will work with a template, which predetermines the role of the board and best practice for directors; others will design a bespoke evaluation for every company. Some will attend to the historic and/or current effectiveness of the board; others will be forward looking, testing the board’s preparation for the future. Several methodologies will be focused on tangible, visible outcomes such as board papers, processes and structures, others will explore less tangible influences such as behaviour, relationships, culture and dynamics.

Chairmen will need to consider how the reviewer’s findings are best communicated in the interests of improving the board’s effectiveness; to present the evidence as an unadulterated mirror image, or as a view to which the reviewer has contributed context, judgment, and recommendations. Inevitably choices will be influenced by, inter alia, the company’s stage in the lifecycle, its size and its geography; current and future issues facing the board, the company and the sector; and board size and composition. There are no right or wrong methodologies, but there are different and decisive board needs, levels of engagement, required skills and competencies, and board outcomes.

Conclusion Although there has been much progress made, these are early days; even the most experienced external reviewers in the UK have been practicing for less than a decade, and best practice is still emerging. However, there is growing evidence that external board evaluation can act as a valuable catalyst for improving the board’s effectiveness and its preparation for future challenges; the ability to construct a private and confidential forum, in which directors can speak frankly and without fear of inappropriate disclosure, and yet which provides an objective and contextualised view, is unique. As this new discipline develops and differentiates, chairmen and their boards, together with their shareholders, stakeholders and regulators, will become more knowledgeable and discerning regarding the range of options available, and the integrity and value of the process.

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