

## **HENLEY CONFERENCE 2006**

### **SPECIAL INTEREST GROUP 1: EFFECTIVE BOARD LEADERSHIP: ORGANISING AND RUNNING A BOARD**

#### **BEHIND AND BEYOND THE BOARDROOM DOOR: Directors and their unreal "real" world**

##### **Abstract**

This paper explores the seeming unreality of outsider's views of the director's world from two perspectives. First, from the "compliance-based" view of boards and directors held by many legislators and regulators, nationally and internationally, that compliance alone is sufficient for effective corporate governance. Second, that all corporate governance happens only around the boardroom table.

The paper attempts to show that both perspectives are not only wrong but that they are cumulatively killing effective board working and, in the long-term, effective wealth generation. Taken to the extreme it argues that crass implementation and political naivety could do more harm to capitalism than Karl Marx ever dreamed.

The paper draws on current personal experiences of board working and demonstrates some of the issues involved in helping to redefine the role and commitment of an effective board, its dynamics, and especially the need to widen its intellectual framework so that it may give the strategic thinking and continuing leadership and learning needed in an increasingly uncertain world. Ultimately this means getting the board to do its "homework".

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## **Two Unreal Yet Common Perspectives Held By Outsiders Of Corporate Governance**

### **1. It's all about Compliance**

The main problem with politicians is that they have only one tool to use in relation to corporate governance - legislation. There only other tool, taxation, has so far not been brought to bear. So there is an in-built tendency to over-use legislation, especially as a knee-jerk reaction to public anger and demands for "something to be done". As the old saying goes "if you only have a hammer then all problems look like a nail".

As the number of Corporate Governance Laws and secondary legislation Codes and laws internationally exceeds four hundred, and many more are promised, a dangerous cottage industry has been born. A bad consequence of this is that more directors and boards are being turned off effective corporate governance through this skewed version of it. Meanwhile, politicians feed the general public with the notion that things are bad but must get better now because they are protecting them through them having redress under more civil and criminal laws that force directors are guaranteed to change their attitudes and behaviours.

This is nonsense. Legislation-backed compliance is necessary but not sufficient. Sufficiency comes from developing individual Board Performance - the continual balancing and rebalancing of the director's dilemma "how do we drive this enterprise forward whilst keeping it under prudent control? But for legislators this is a problem as the uniqueness of the experiences, values, skills and care of a board does not allow for easy legislation relating to this dynamic balancing act. "Prudent control" can be specified relatively easily and is, therefore, open to legislation. The problem is that "driving the enterprise forward" is not. That is why we pay boards of directors - to take risks on behalf of the development of the company. Legislators cannot foresee the future in a turbulent world, nor will they know the detailed organisational capabilities of a specific business. It is for the directors to be risk-aware and then take the decisions necessary to ensure that they fulfil their fiduciary duty within their directoral duties of Care and Skill.

There is an attitudinal and behavioural problem here as an over-concentration on risk reduction can lead to a legislative culture which is

risk-averse because it reduces the risk appetite of both directors and managers; as seen when the Health & Safety issue is taken to absurdity. It is worth remembering that the word "risk" derives from the Old Italian *riscare* which means "to dare". Directors need to be risk-aware, not risk-averse. Directors are paid to take thoughtful risks. But the overblown requirements of such legislation as the Sarbanes-Oxley Act, whilst well-intentioned, have reinforced greatly the risk-averse or even risk-avoidance culture in many companies and countries. The US has a very robust Fraud Law and it is worth noting that, for example, the Enron case was prosecuted successfully under it, not SOX.

The consequences of creating such a risk-averse culture challenges the very essence of capitalism - the risk/reward calculation. At the extreme we have to wonder if SOX will do more to undermine capitalism than Karl Marx could ever dream? Will too much corporate governance legislation, done for the best motives, undermine economic and social development by increasing risk-aversion? The question becomes increasingly important as a number of countries move towards the annual "triple bottom line" reporting system, where financial, environmental impact and corporate responsibility all have their own auditors.

## **2. It's all happens around the boardroom table**

The faults of a compliance-only based approach to corporate governance are then compounded by directors as much as legislators by an attitude that all board activities happen only around the boardroom table. Indeed, there is a strong feeling amongst directors and the general public that the board only exists when they are meeting formally. This, too, is patent nonsense. A director is a director twenty four hours a day. Directors are "always on". Legal accountabilities and liabilities do not cut in and out dependant on your proximity to the boardroom table.

There is a problem here for many directors as they have often accepted their role on the working assumption that it will "only take a few days of my year". This is untrue if you are to be an effective director and deliver board performance. Apart for dealing with the agenda issues and the committee commitments you will always be scanning the changing external environment and thinking about how this affects your company. Done well, this means that you will spend around a day a week on company issues. Which means that you could only ever handle a maximum of four directorships at any time. Which means that you would need to be paid well for each.

This will upset many existing directors. I make no apology for this because I am seeking to create a cadre of professional, independently thinking directors not a coterie of "nice to have" executives sitting on each other's boards. Taking this approach should increase the diversity of boards, their capacity to think strategically and so their ability to deliver added shareholder value.

### **Towards Reality**

To make this happen requires a rigorous Board and Director Induction, Evaluation and Development process under the supervision of the Chairman. It requires that each director is treated precisely as that - a director, not an Executive Director or a Non-Executive Director. It requires that they commit to at least annual evaluation both individually and as a board member. Whilst this is required under the UK's 2003 Combined Code it is usually done in a minimalist manner with as much box ticking as possible. That was not the thinking behind the 2003 Code. Such evaluation is as much of their generalist ability to scan the external environment, think strategically and take risks to fulfil their fiduciary duty as to exercise their functional specialism internally.

Such new risks are obvious and worth taking, if we are to ensure that boards truly add shareholder value. For without establishing professional directors, whether accredited or not, the legislators will go on creating more laws and regulations and the whole essence of directoral "comply or explain" risk-aware risk-taking will descend into a life of "tick box" routines. Does any director want that kind of reality? We need to fight for board performance being rated as high as prudent control.

Bob Garratt

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