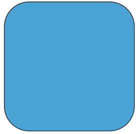

WRESTLING WITH UNKNOWN UNKNOWNS — THE DILEMMA OF THE NONEXECUTIVE DIRECTOR IN THE UK

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ALISON HOGAN

In an increasingly complex, fast-changing, and interconnected world, it is a constant challenge for independent, nonexecutive directors of boards to have a clear mandate and be truly effective in their roles as custodians of an organization on behalf of all its stakeholders.[1]

The challenge is not new. Attempts have been made over the last 25 years or so to respond to successive corporate crises with reviews and guidance on good corporate governance. Each raft of new guidance adds greater, more specific, and, arguably, more onerous responsibilities on boards. This constantly challenges the independent directors' individual and collective capability and, particularly when things go wrong, their accountability.

Their stewardship role, on behalf of all stakeholders, including shareholders, is increasingly under scrutiny, particularly in an environment where trust in business leaders is low.

According to Tony Manwaring, chief executive of the global think tank Tomorrow's Company, "All the complications of

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our times fall on the shoulders of the board."[2]

At worst, the roles of independent directors are viewed as having little or no value to businesses. At best, they are seen as vital, acting on behalf of stakeholders in supervising and holding to account the chief executive and the executive team.

Tomorrow's Company suggests that the purpose of a unitary board (comprising both part-time nonexecutive and full-time executive directors) is to create value more effectively over time than the executive of the company could do on his or her own.

> It is precisely the interaction between the executive and the non-executive directors, with their different experience, perspectives, and knowledge bases, which should create a better stream of value and understanding of risk and opportunity for the benefit of investors and stakeholders.[3]

However, as organizations have become more complex, operating in more complex environments, fewer boards are able to contract, clearly and definitively, their individual and collective responsibilities. They may seek to create a better understanding of risk and opportunity, as Tomorrow's Company suggests, but when such efforts fall short, it is difficult to clarify precisely where responsibility lies.

The bar has been raised — and continues to be raised — on the level of understanding and engagement that the board is expected to have to continue to fulfill their role of stewardship and oversight of management.

Within a unitary board, executive directors have the same duties as other members of the board, duties that extend to the whole of the business and not just that part of it covered by their individual executive roles. According to the U.K. Financial Reporting Council (FRC), "taking in the wider view can help achieve the advantage of a unitary system: greater knowledge, involvement, and commitment at the point of decision."[4]

For their part, nonexecutive directors need to make the time and have the capacity to have a strong command of the issues relevant to the business so they can make a positive contribution. This can only be achieved if the executives provide the high-quality information that enables them to make well-informed decisions based on a clear line of sight into the business.

Executive directors have to balance the value of the insights and guidance that the nonexecutive directors bring with what can sometimes feel like onerous commitments to keep them sufficiently briefed. Nonexecutive directors need to come to grips with the business whilst also having the confidence to ask the "big, stupid questions" that may be overlooked.

While the whole board makes decisions, at the crux of the dilemma for the unitary board is the tension in differentiating the precise accountability of executive and nonexecutive directors. When there is a corporate crisis and stakeholders look to hold the board to account, the spotlight falls increasingly on the nonexecutive directors, particularly when the CEO and other executive directors have been implicated in the failure.

When concerted efforts to provide guidance on best practices began some 25 years ago, the role of the board and the nonexecutive director was much simpler. The primary role was to bring a legitimacy and authority to the board by virtue of their professional experience and the senior positions they had held. One of the earliest initiatives to clarify corporate governance in the U.K. was the Cadbury Report in 1992. It said that the responsibilities of the board included setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business, and reporting to the shareholders on their stewardship.

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For many board directors, fulfilling these responsibilities could be accomplished by attending perhaps six board meetings a year and, sometimes but not always, reading the board papers in detail in preparation. However, the reality today is that the roles of supervision, stewardship, and strategizing are far more complex and time-consuming. Board

development has not kept pace with the demands and expectations of a more discerning and demanding range of stakeholders. Guidance on corporate governance does not make allowance for the significant differences in the appropriate level of governance for very different types of organizations. As a result, reaching a consensus on what is best practice is difficult.

According to Guhan Subramanian, "achieving best practices has been hindered by a patchwork system of regulation, a mix of public and private policy makers, and the lack of an accepted metric for determining what constitutes successful corporate governance." He goes on to say that the nature of the debate does not help either. "The result is a system that no one would have designed from scratch, with unintended consequences that occasionally subvert both common sense and public policy."[5]

ONE OF THE MOST CONTROVERSIAL PROPOSALS IS A PLAN TO INTRODUCE A "SENIOR MANAGER REGIME" (SMR), WHICH BRINGS A POTENTIAL CRIMINAL LIABILITY UNDER A NEW OFFENSE FOR RECKLESS DECISIONS THAT CAUSE A FINANCIAL INSTITUTION TO FAIL.

It was the global financial crisis that provoked the most detailed and rigorous review of corporate governance in recent years. The Walker Report, published in November 2009, was a detailed and wide-ranging review of corporate governance of U.K. banks and other financial institutions. Nevertheless, it has proved to have significant applicability to nonfinancial companies and is reflected in subsequent updates of the U.K. Corporate Governance Code.

Since the Walker Report was published, financial scandals have continued to emerge, including the collapse of Royal Bank of Scotland and HBOS as well as the rigging of Libor rates. As a result, the Bank of England's Prudential Regulation Authority and the Financial Conduct Authority published new proposals for a stricter regulatory regime in July 2014.

These continuing crises have highlighted the difficulty and uncertainty in defining precisely where responsibility and accountability ultimately rests. One of the most controversial proposals is a plan to introduce a "senior manager regime" (SMR), which brings a potential criminal liability under a new offense for reckless decisions that cause a financial institution to fail.

SMR would create a presumption that senior managers are guilty of misconduct if they fail to show that they took adequate steps to prevent a serious breach of regulation. Such a proposal was perhaps inevitable, not only because of the failure of governance guidance to prevent successive crises, but also, in the aftermath of such crises, the failure to identify and hold accountable particular individuals within the failed organizations.

What has caused some consternation is the possibility that the SMR could extend to include some nonexecutive directors such as the chairmen of the audit or remuneration committees. This proposal has been described as too draconian, raising concerns about personal liability and suggestions that it will become increasingly difficult to make board appointments.

Sir David Walker, five years after the publication of his review and speaking from his current position as Chairman of Barclays, said in an interview with the *Financial Times* that the proposed SMR, if extended to nonexecutive directors, risked undermining their role and the function of the unitary board. "You are either risk-averse, saying let's not do anything, then I'm safe, or if we are going to do something then I want to be all over you."[6]

Whilst these particular proposals focus on banks, as the Walker Report has shown, governance directed at one sector often, over time, influences guidance and practice more widely. The law of unintended consequences could be that simply surfacing the issue of personal liability may open up a wider debate, in due course, that looks at the applicability for other organizations, thus further raising the bar for nonexecutive directors.

Certainly, if not addressing the issue of personal liability, the objective of clarifying a board's responsibilities in risk management has been taken up more widely. As far as banks go, Walker believes that the proposed stricter regulatory regime will encourage banks to take greater responsibility for their actions as a result of "the combination of clearer indi-

vidual responsibilities and enhanced risk management incentives."

This is echoed in an updated version of the U.K. Corporate Governance Code issued in September 2014. It reflects a sea change in thinking about the assessment and reporting of risk and business prospects. It suggests that nonexecutive directors are expected to satisfy themselves on the integrity of financial information and also that financial controls and systems of risk management are robust and defensible.

The guidance will help to clarify the role of nonexecutive directors. The challenge will be how the board (nonexecutive and executive) collaborates to enable such oversight to be possible. This depends on board dynamics and, recognizing this, the code suggests that the chairman should promote a culture of openness and debate, "facilitating the effective contribution of nonexecutive directors in particular and ensuring constructive relations between executive and nonexecutive directors."

Sir David Walker, when asked what new points he would include if he was writing the Walker Report today, said that "the biggest change that I would want to make is to propose that the need is not only to focus on hard risk, where the world is a much better place, but also to focus on soft risk, or culture."[7]

Thus, at Barclays he proposed two additional board committees. The first would deal with conduct, operational, and reputational risk, and the second would deal with broader enterprise-wide risks, including the "unknown unknowns" that former U.S. defense secretary, Donald Rumsfeld, made famous.

Any amount of guidance cannot guarantee that a board will be adequately prepared for unforeseen events. Thus, when it was revealed that the U.K. retailer Tesco had overstated its latest profits forecast by £250 million, the *Financial Times* quoted the Chairman, Sir Richard Broadbent, as saying, "Things are always unnoticed, until they are noticed."[8]

The *Financial Times* suggested that the scandal "lays bare a further weakness in the UK's system of self-regulation. The integrity of Tesco's accounts ultimately depended on the skill of the non-executive directors. Yet, until the scandal broke none of them had any relevant retail expertise."[9]

Certainly, relevant industry expertise should be a part of the mix of skills and experience within a board. However, the assumption amongst some stakeholders and commentators is that the Tesco board should have been able to identify the problem, even though the auditors had failed to note it.

This highlights the dilemma and the inherent instability in the structure of a board that includes both executive and nonexecutive directors. In addition to acquiring sufficient knowledge and understanding of the business, the boardroom needs to be a place where challenge and generative thinking is encouraged.

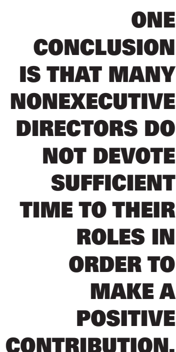
IN ADDITION TO ACQUIRING SUFFICIENT KNOWLEDGE AND UNDERSTANDING OF THE BUSINESS, THE BOARDROOM NEEDS TO BE A PLACE WHERE CHALLENGE AND GENERATIVE THINKING IS ENCOURAGED.

Sir David Walker emphasized the importance of focusing on soft risk or culture, and the updated code also highlights the importance of the board's role in establishing the "tone from the top" of the company in terms of its culture and values. The directors should lead by example in order to encourage good behaviors throughout the organization.

The FRC emphasized that the key to effective functioning of any board is a dialogue that is both constructive and challenging. "The problems arising from 'groupthink' have been exposed in particular as a result of the financial crisis."[10]

Guarding against "groupthink" is, therefore, a major element of the chairman's leadership. Refreshing the board over time and ensuring genuine diversity are two ways of countering this. Some argue that in extending the net more widely and being more demanding in role requirements, recruitment has become harder. This may be a positive development if more stretched assignments result in the appointment of high-quality, independent-minded candidates who understand the demanding environment within which the board operates and the commitment required to be an effective board member.

Such a shift in board membership will require a new mandate, a redefinition of



ONE CONCLUSION IS THAT MANY NONEXECUTIVE DIRECTORS DO NOT DEVOTE SUFFICIENT TIME TO THEIR ROLES IN ORDER TO MAKE A POSITIVE CONTRIBUTION.

the roles and responsibilities of executive and nonexecutive directors and the relationships between them. It will require a different distribution of power and a culture of openness, trust, and transparency, or what James O'Toole and Warren Bennis describe as a culture of candor. They suggest that truly independent boards would go a long way toward providing a needed check on executive ego and a source of objective truth-telling. However, if a team suffers from groupthink and doesn't know how to disagree with each other, then a problem of transparency arises.

"Shared values and assumptions play a positive and necessary role in holding any group together. But, when a team of senior managers suffer from collective denial and self-deception — when they can't unearth and question their shared assumptions — they can't innovate or make course corrections effectively."[11]

An alternative model of board leadership has been proposed by Ram Charan, Dennis Carey, and Michael Unseem. This model has emerged from the developments of the last decade, including increased regulation, shareholder pressures, and governance reforms. These developments have resulted in a strengthening of the board's oversight function and are also leading to a more directive and, potentially, more collaborative leadership of the company. They note that boards are already taking charge of areas such as CEO succession, executive compensation, goal choices, and merger decisions. They quote Sir David Walker, upon his appointment as nonexecutive chairman of Barclays, as saying that boardrooms "have been too reactive, passive and accepting of what's proposed by the executive."[12]

The model that they propose does not mean micromanagement "but it does require directors to educate and interest themselves in company strategy, risk management, and talent development." They acknowledge that, if poorly handled, this new board enablement can cause serious damage, resulting in fractured authority and dangerous meddling. It calls for effective leadership by the board and requires a practical road map for knowing when boards should lead, when they should partner, and when they should stay out of the way.

It is a pragmatic model that accommodates the changing demands on the board to meet new business challenges and stakeholder expectations. The authors have examples of boardrooms that demonstrate a more directive and collaborative leadership, including Proctor & Gamble, Apple, Ford, and Lenovo.

Andrew Kakabadse, professor of governance and leadership at Henley Business School, counters these case studies with data that indicate how far many boards have to come in their development before they are likely to embrace such an approach. His research of leading FTSE companies identified that over 80 percent of board members don't know what the competitive advantage of their firm is; whilst a global review of top management across 12 countries revealed that in nine out of 12 countries, more than one-half of the respondents said that they were too inhibited to talk openly with their boards about issues they felt should be discussed.

Kakabadse's research is reinforced by separate research from McKinsey, who conclude that most boards aren't delivering on their core mission to provide strong oversight and strategic support for management's efforts to create long-term value. In a survey undertaken in 2013, only one-third of the 772 directors interviewed agreed that the boards on which they served fully comprehended their companies' strategies; only 22 percent said their boards were completely aware of how their firms created value, and 16 percent claimed that their boards have a strong understanding of the dynamics of their firms' industries.[13]

Kakabadse, who has led a global study of boardroom effectiveness and governance practice, is skeptical about the value that nonexecutive directors bring to the business and of the quality of engagement and dialogue between them and executive directors.

One conclusion is that many nonexecutive directors do not devote sufficient time to their roles in order to make a positive contribution. His research shows that many nonexecutives hold

between four and 30 such positions, which makes it impossible for them to fully understand what is happening at the heart of the organization. "Board members simply don't have time to deal with the responsibilities of the job and so avoid challenging their counterparts on core issues affecting a business."

There is an acknowledgement of the increasing level of commitment of time and the complexity of issues that have to be grasped. As a result, for many boards, the number of days that a part-time, nonexecutive is expected to commit has increased significantly. Recommendations on the number of days that should be dedicated to the job vary from two to three days per month for large, publicly quoted companies, to 54 days per year as the standard for directors of companies owned by private equity firms, according to a McKinsey study in the United Kingdom.[14]

Some nonexecutive directors would argue that the implications of their extended remit has not been fully recognized and that their role is both undervalued and underpaid.

A think tank, led by U.K.-based Board Intelligence, that involved 300 board directors found that while 72 percent of participants believed that a nonexecutive position on a FTSE board is a privilege, the remaining 28 percent signified that it was a "hiding to nothing."

The dilemma for any board is how to acknowledge and manage the inevitable tension that can arise between executive and nonexecutive directors over levels of influence and control when contentious issues arise. At its best, the tension can enable constructive dissent and generative dialogue and, at its worst, it can be a source of friction that creates damaging fault lines within the board.

In identifying an effective board, the role of the chairman of the board is pivotal. Theirs is a leadership challenge that cannot be underrated. The U.K. Corporate Governance Code suggests that:

> ...to run a corporate board successfully is extremely demanding. Constraints on time and knowledge combine with the need to maintain mutual respect and openness between a cast of strong, able, and busy directors dealing with each other across the different demands of executive and non-executive roles.

In the words of Sir Roger Carr, the highly experienced Chairman of BAE Systems:

> If you set the right climate, you get great people. With great people comes great chemistry — people willing to say what they think; making added value contributions in an atmosphere where executives feel supported where appropriate, and challenged when necessary.
>
> If you get self-seeking, power-hungry egotistical nonexecutive directors who are there to promote themselves and prove something to the outside world, it becomes adversarial and dysfunctional.

Some boards have taken steps to improve their effectiveness, for example, by moving to smaller and more diverse boards and by shifting the balance of time devoted to strategy rather than past performance. However, there is little indication of any major changes to structure or composition happening in the near future. The onus, therefore, is on the individual who wishes to join a board as a nonexecutive to do their homework about the reputation of the organization and its leadership, including its performance and culture. Equally important is to get clarity about their roles and responsibilities, the time commitment required, and, from the organization, a firm commitment to help them develop a sound understanding of the business and its risk profile so that they can make a well-informed contribution to board discussions. Finally, they need to reflect as candidly as possible about their motivation for applying for the role of nonexecutive director. ■

THERE IS AN ACKNOWLEDGEMENT OF THE INCREASING LEVEL OF COMMITMENT OF TIME AND THE COMPLEXITY OF ISSUES THAT HAVE TO BE GRASPED. AS A RESULT, FOR MANY BOARDS, THE NUMBER OF DAYS THAT A PART-TIME, NONEXECUTIVE IS EXPECTED TO COMMIT HAS INCREASED SIGNIFICANTLY.

NOTES

[1] This article uses the U.K. term "nonexecutive director," but its conclusions are equally applicable to independent directors in the U.S., Europe, or Asia.

[2] Stern, S., Good governance is about more than just numbers, *Financial Times* (2014). Available at: http://www.ft.com/intl/cms/s/0/c2c81c60-4af9-11e4-b1be-00144feab7de.html#axzz3TXBH18tw.

[3] "Tomorrow's corporate governance: The case for the 'board mandate,'" Tomorrow's Company (2010). Available at: http://tomorrowscompany.com/board-mandate.

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Corporate-Governance/Guidance-on-Board-Effectiveness.pdf.

[5] Subramanian, G., Corporate governance 2.0, *Harvard Business Review* (March 2015). Available at: https://hbr.org/2015/03/corporate-governance-2-0.

[6] Arnold, M., Barclays chairman Walker swipes at Peace over multiple roles, *Financial Times* (2014). Available at: http://www.ft.com/intl/cms/s/0/32453f72-7fd5-11e4-acf3-00144feabdc0.html#axzz3TWqtj7dL.

[7] *Ibid.*

[8] *Op. cit.* note 2.

[9] Picking up the pieces after Tesco's stock affair, *Financial Times* (2014). Available at: http://www.ft.com/intl/cms/s/0/341f1c2a-5b75-11e4-a674-00144feab7de.html#axzz3TWqtj7dL.

[10] *Op. cit.* note 4.

[11] O'Toole, J. and Bennis, W., A culture of candor, *Harvard Business Review* (June 2009). Available at: https://hbr.org/2009/06/a-culture-of-candor.

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[13] Barton, D. and Wiseman, M., Where boards fall short, *Harvard Business Review* (Jan 2015). Available at: https://hbr.org/2015/01/where-boards-fall-short.

[14] *Ibid.*