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THE CHAIRMEN'S RESEARCH GROUP

REVIEWING BOARD EFFECTIVENESS

A STUDY OF CURRENT PRACTICE

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THIS IS THE CHINESE EXPRESSION FOR EFFECTIVENESS

OCTOBER 2010

Manchester Square Partners

Manchester Square Partners undertakes board review, mentors CEOs and Directors and advises Directors on career progression and change.

The Chairmen's Research Group

The Chairmen's Research Group was established by Manchester Square to explore the developing issues within Chairmanship and to create a platform to accelerate the cross-pollination of the most effective solutions to problems commonly encountered. The Group operates under the Chairmanship of Sir David Lees and with the on-going guidance of a steering group of Chairmen of FTSE 100 and 250 companies.

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PARTICIPANTS

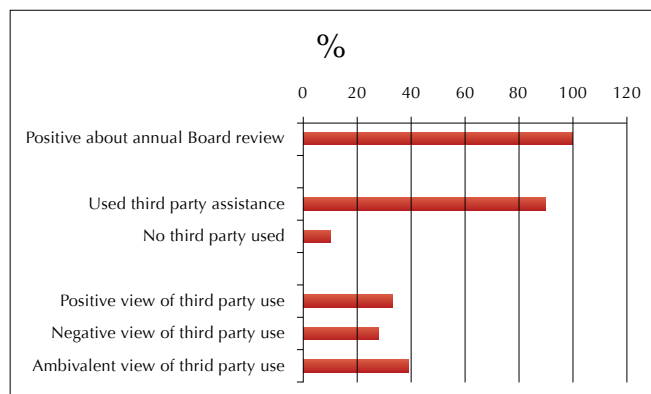
Jonathan Agnew	Chairman, Beazley plc
John Allan	Chairman, Dixons Retail plc
Norman Askew	Chairman, IMI plc
Charles Berry	Chairman, Drax Group plc and Eaga plc
Sir Win Bischoff	Chairman, Lloyds Banking Group plc
Bruce Carnegie Brown	Senior Independent Director, Close Brothers Group plc
Alison Carnwath	Chairman, Land Securities Group plc
Dominic Casserley	Partner, McKinsey & Co.
Ian Davis	Managing Director Emeritus, McKinsey & Co
Sir John Egan	Non Executive Director, MODEC plc
Nick Ferguson	Chairman, SVG Capital plc
Simon Fraser	Chairman, Foreign & Colonial Investment Trust plc
David Fletcher	Chairman, Odey Asset Management LLP
Sir Peter Gershon	Chairman, Tate & Lyle plc and Premier Farnell plc
Peter Gibbs	Non Executive Director, Intermediate Capital Group plc
Dr Alan Gillespie	Chairman, ERSC
Sir Philip Hampton	Chairman, Royal Bank of Scotland plc
Michael Harper	Chairman, BBA Aviation plc
Sir Christopher Hogg	Formerly Chairman, Financial Reporting Council

Conor Kehoe	Partner, McKinsey & Co
Sir Richard Laphorne	Chairman, Cable & Wireless Communications plc
Jim Leng	Non-Executive Director, Alstom and TNK-BP plc
Sir David Lees	Chairman of the Court of Directors, Bank of England
Sir Robert Margetts	Chairman, Huntsman Corporation
Dr Chris Masters	Senior Independent Director, Wood Group plc
Mike McTighe	Chairman, WYG plc and Pace plc
Dick Olver	Chairman, BAE Systems plc
Patrick O'Sullivan	Chairman, Old Mutual plc
Sir John Parker	Chairman, Anglo American plc and National Grid plc
Will Samuel	Chairman, Howden Joinery Group plc
Ron Sandler	Chairman, Northern Rock plc and Phoenix Group Holdings Ltd
Robert Swannell	Chairman Elect, Marks & Spencer plc
Tony Ward	Senior Independent Director, SThree plc
Robert Webb	Chairman, Autonomy Corp plc and BBC Worldwide Ltd
John Whybrow	Chairman, Wolseley plc
Margaret Young	Chairman, Cattles plc

The interviews were conducted in collaboration with Professor John Stopford, Professor Emeritus, Strategy, London Business School, and Max Weston and Charles MacDonald of Panthea Leadership LLP.

SUMMARY OF RESEARCH FINDINGS

1. We interviewed 30 Chairmen of FTSE 350 companies* about how they undertake reviews of board effectiveness. Our study revealed that the practice of reviewing board effectiveness remains in its infancy, partly because effectiveness as a term is undefined.
2. Many of the reviews we discussed still seemed to evaluate governance rather than the broader issue of effectiveness. Nonetheless the trend is clear: an initial focus on process and governance has been expanded to include the group dynamics of the board, and now is shifting to encompass a focus on how the board is contributing to the underlying business.
3. Chairmen agreed unanimously that there is substantive value in undertaking an annual board review, but were less consistent about how to involve an external third party, and about the value to be gained from doing so.
4. The choice between internal and external review was not binary. Some Chairmen adopted a hybrid approach in which they, with a third party, designed a process for that external third party to carry out. In comparison with the relatively standardised approach that some third party reviewers propose, these hybrid reviews tended to focus more on board engagement with the business and its strategy.
5. The main reservation about the value of using a third party concerned the levels of business insight and judgement and, to a lesser extent, the level of objectivity the current providers of external review could be expected to bring to bear. In our conversations with participants, it emerged that these concerns could be addressed if the reviewer was a fellow senior business person, a peer, although some thought that this would in practice be difficult to arrange. In whatever circumstances, those who were dissatisfied with externally facilitated review as usually provided expressed a desire to see a development in the analytical input provided in any review.



Conclusion:

Following this research, we are working alongside Chairmen to devise methodologies to help them develop review processes which will generate insight into a wider definition of effectiveness.

For further observations and the outcomes of the research rather than the findings alone, please see page 14.

** We also gathered the views of some board members and Advisors whom we knew to have informed views on the effectiveness of boards, and of board review. The statistics only include the views of those with personal experience of Chairing.*

BACKGROUND TO RESEARCH AND METHODOLOGY

The Chairmen's Research Group

The Chairmen's Research Group was established to identify the drivers of effective chairmanship and to accelerate the cross-pollination of experience and therefore of the most effective ideas and approaches. Appreciating that Chairmen conduct their effectiveness reviews very differently, we undertook this research in order to understand better the range of approaches used and to identify emerging trends.

Thirty Chairmen of listed companies in the FTSE 350 volunteered to be interviewed.

We asked them:

- Why they undertook Board reviews
- Why they involved third parties or not
- Which third party reviewers they had selected and why
- What their approach had been to the review process
- What they had found to be of value in external review

We also talked to a number of providers of external review services and to other board advisors.

DETAILED FINDINGS

1. Motivation for undertaking a review, internal or externally facilitated

- 1.1 All Chairmen interviewed said that they reviewed the effectiveness of their board annually. Most saw an annual internal review as a sine qua non of good practice in chairmanship. Some participants evinced a greater enthusiasm for doing so, and for developing the best review methodology, than did others. However, there was universal agreement that board members gain from undertaking an annual review of how they are operating as a board.
- 1.2 The motivation for involving a third party was generally the belief that an extra degree of objectivity would be helpful in particular circumstances. Some of those interviewed felt that a new Chairman could benefit from external analysis of 'what he's got'. Some commented that a Chairman who had had to cope with a disruptive event could afterwards benefit from external help in addressing the issue. Otherwise, external involvement was generally regarded as a way of 'conducting a health check'.
- 1.3 There was no evidence of an agreed definition of board effectiveness underpinning this rationale – for example in terms of the agenda or goals that the Chairmen were setting for the review process. This was the case for both internal reviews and for those with external input. There were subjective views of what a good outcome would look like, but no benchmark to adopt in undertaking such an exercise.
- 1.4 In the majority of instances, the reviewers' focus was not addressing board effectiveness per se, but centred on checking the board's adherence to good governance practice. This differed from the content of the reviews of a small minority of participants who focused directly on how their board was adding value to the business, on the quality of the board's engagement with the business and on its strategy. The contrast between the reviews of these two groups was stark.
- 1.5 For internally managed reviews, the majority view of a good outcome was conformity with (undefined) standards on:
 - The quality and timeliness of information
 - The operation of committees
 - An appropriate representation and the quality of capabilities represented around the table
 - Group dynamic including the Chairman/CEO relationship
 - The board's involvement with strategy
 - Succession planning
 - Risk management
 - Whether or not the board is well chaired.

- 1.6 The failure to set an objective standard of effectiveness before embarking on an internal review was seen by some as indicative of why some reviews were markedly less productive of insight than others. In the words of one participant, "Some evaluations are not challenging enough in what they address and how they evaluate themselves. Most boards end up congratulating themselves." Even with external involvement, standards of objectivity could be less than challenging. One Chairman told us that he felt that his recent board review, undertaken through a third party, was very satisfactory because he had heard nothing that surprised him.

2. Criteria for choice of third parties

- 2.1 We asked how participants would choose third party reviewers. They were broadly equally divided between those who selected on the basis of existing relationships of trust and of knowledge of the business, and those chosen on the recommendation of other Chairmen.
- 2.2 We found that the market of external reviewers used by these Chairmen was fairly concentrated. Eleven firms or individuals were mentioned, two of whom conducted 35% of the reviews between them.
- 2.3 Those reported as having been used as reviewers were:
- Two Business School Professors (three reviews)
 - One major global executive search firm (two reviews), three specific partners in 'boutique' search firms with one in particular reported on eight reviews and one other search firm conducted two reviews
 - ICSA (six reviews)
 - One independent professional with a background in psychology (eight reviews)
 - Independent Audit (two reviews)
 - Corporate communications advisors (three reviews).
- 2.4 Of anecdotal interest was a marked preference when selecting individuals rather than firms, for the use of senior women with established competence. They were felt to bring empathy and the ability to disarm competitive instincts, which helped achieve unguarded openness when eliciting board members' views. The academics and other providers tended to be men.

3. Perceived value added by external reviewers

- 3.1 A third of participants believed that external input was likely to deliver substantive value. The remaining two-thirds believed that, in their experience, third party input had been of only marginal added value, or was in principle unlikely to bring substantive value.
- 3.2 The third of participants who saw 'definite value' in using a third party identified the benefits as in bringing objectivity to the process, gaining a comparative view of themselves relative to other boards and cross-pollination – the chance to learn of good ideas and approaches from elsewhere, or as confirming their own impressions of the effectiveness of their board.
- 3.3 The majority regarded the Financial Reporting Council's (FRC) provision on external review every 3 years at best neutrally: "as an irritant that we will live with, because we don't want the hassle of explaining rather than complying – and we would probably do it anyway"; "On balance it is better from time to time to do a review with a third party as a health-check than not to do so". Even then, they were concerned about the intrinsic value of the exercise. In the words of one: "You get objectivity, but of course what you get in the end is a kind of superficial objectivity."
- 3.4 One third of the participants remained reluctant to involve an external reviewer. This group was not homogenous, including those of opposite views on other issues, such as their openness to external input on a broad range of matters. Two participants regarded it as 'absurd' that a third party could bring value to them and their board. Others had tried the idea and found little or no added value. In the words of one sceptic: "The market has failed to deliver a methodology or set of consultants with the insight, objectivity and renown required to truly add value to a board that wishes to challenge itself."
- 3.5 The perceived objectivity of the reviewer seemed to be a matter of increasing concern to the contributing Chairmen. The FRC requires that any other links that a board reviewer has with a company be disclosed. Several participants who believed in the honest objectivity of trusted individuals, such as executive search consultants whom they knew well and who in turn knew their business, found it regrettable that they were going to have to explain their decision to use them.

4. Process – the norm

- 4.1 In three cases, the questionnaire was ‘done away with’ and questions asked to board members face-to-face by the Chairman over dinner or similar. Otherwise, we found considerable homogeneity in the processes adopted for both internal review and where a third party was involved.
- 4.2 The great majority of reviews, internal and externally facilitated, involved a questionnaire designed to elicit board members’ assessment on a scale of 1-5, with some scope for comments on a number of aspects of the board’s operations. The norm is for the Chairman, or often the Company Secretary, or any third party involved then to take the content of the questionnaire as the basis of a conversation or interview. A report is compiled for the Chairman (or for the board if the Chairman undertook the Review), combining the questionnaire and interview data.
- 4.3 Third party reviewers’ questionnaires covered largely the same content as those designed in-house, but with additional elements reflecting the reviewer’s area of expertise. In several instances, internal reviews involved a pro-forma questionnaire that the board had used on previous occasions without variation. Third parties’ proprietary questionnaires had some, but not extensive customisation for the client.

In approximately a fifth of instances, the questionnaire was crafted chiefly by the Chairman who then used a third party to facilitate the conversations. This hybrid approach correlates highly positively with a focus on board members’ engagement with the business.

Questionnaires typically cover board members’ satisfaction with:

- The quality of board papers
- Agenda setting
- Committees
- The quality of the group dynamic
- Feedback on the contribution made by peers
- Board composition
- The relationship between the Chairman and CEO
- Feedback for the Chairman on his chairmanship

5. Variations in Process

5.1 Any variation was generally in:

- The degree to which the Chairman alone or with a colleague crafted the process as opposed to adopting that of a third party consultant. We observed that while they varied, those reviews chiefly crafted by Chairmen themselves, with or without a questionnaire, tended to focus less on process and board dynamics than those adopting a proprietary third party questionnaire. This was especially true of the three participants who eschewed questionnaires entirely. These reviews typically sought to adduce evidence of board members' views on their roles as board members and to gauge their engagement with the business.
- Whether or not board members were asked to evaluate their peers. The majority of participants strongly advocated doing so, except for example when a board was relatively newly formed.
- In externally facilitated reviews, some Chairmen had the external third party present their findings to them accompanied by the Senior Independent Director or the Company Secretary. Their objective in doing so was to give the board comfort that they had not 'sanitised it by editing out the difficult parts'.
- The degree to which board members' contributions remained anonymous. In only two cases was the report wholly attributed and only in one, wholly unattributed.

All participants reported that, following the board's discussion of the findings, a set of actions was agreed for the board's development over the next period and reviewed periodically.

THE FRC'S DEFINITION OF EXTERNAL FACILITATION

- 6.1 The FRC's Revision to the Code of Governance in June 2010 states simply, in schedule B.6.2, that 'Evaluation of the Board of FTSE 350 companies should be externally facilitated every three years'. The Code contains no explanation of what facilitation entails and we found no common interpretation of what it means in practice.
- 6.2 The Oxford English Dictionary defines facilitation as 'to make easier'. We interpret the regulator's choice of the word as purposely general and vague, with the intention not to limit the manner in which external reviews are managed, nor to impose a single model of, say, highly interventionist or relatively light touch reviews. We approached the FRC to clarify their intention and their response supported our view.
- 6.3 Within this broad definition, the use of external reviewers can take a number of forms. A minimalist approach where the Chairman does no more than discuss his own conclusions with an outside expert could be as valid as one where the review which is conceived and conducted entirely by an outside reviewer. Both were felt by our participants to have their place in the right context.
- 6.4 Those Chairmen who have chosen to act as the chief architect of their reviews, defining the procedures and identifying the focus and questions for an external reviewer to use, will most probably also remain at liberty to continue doing so. Our observation from this study is that the reviews which were most challenging of the Board's contribution to the business were led by the Chairman himself, with or without a third party facilitator.

OUR OBSERVATIONS AND PRACTICAL OUTCOMES

Evolution of the agenda

- 7.1 The Effectiveness Review is clearly at an early stage of its evolution. At its inception, with the Cadbury Report in 1992, the focus was primarily on board administration. Over the last decade, it has moved towards also assessing behaviours and the group dynamic. In this review of current practice, we identified an emerging trend. That is, to take account of the factors already mentioned, but to do so in the context of a board taking a self-confident but self-critical challenge of what the board is adding to the business, and how it is doing so.

Development of new methodologies and dilution of the market for Board review

- 7.2 As Effectiveness Review evolves, there is a desire to derive new methodologies. New practitioners will come into the market and the market itself will develop, driven by the stipulations of the Code. This is likely to lead to a reduction in the use of executive search consultants as reviewers.

Peer review as a concept

- 7.3 The concept of 'peer review' is the first creative output of the Chairmen's Research Group. Some participants stated that consultants do not consistently bring the insight, judgement and objectivity that they would value in any external reviewer. We asked where such qualities might be found. Interviewees identified 'senior Board members elsewhere', or in the development of more analytical frameworks when used by other reviewers. The idea of review by a member of another board emerged. After initial scepticism, the idea has been received positively.
- 7.4 The essence of a peer review is that a Chairman would ask another Chairman to spend time with the board, to help identify areas where that board could be more effective. The invited reviewer would need relevant experience, a style aimed at generating insight rather than judgement, and little or no pre-existing relationship with the client Chairman or other conflict of interest. While qualifying as external facilitation of a review, this would take the form of a conversation between two peers, where objectivity has to be relied upon in the independence of mind of the parties involved.

Some members have volunteered to be reviewers, and on other occasions, to be reviewed by a peer, on a trial basis. In such review, Manchester Square Partners' role will be to help manage the process and to record the learning.

A review methodology focused on evidence of effectiveness

- 7.5 Following this study, we have been asked to synthesise what we know to be important in Board review and to conduct effectiveness reviews ourselves. Our approach focuses strongly on acting as facilitators of the Chairman's process and developing evidence to generate insight which a board can use to evaluate how it is, and is likely to continue adding value to the business.
- 7.6 From this study of current practice, we are acutely mindful of the contextual nature of how a review must reflect a board's position on its own evolutionary cycle. There is no one-size-fits-all and Chairmen will want to bring in reviewers with the appropriate background and approach dependent on where they want to lay emphasis at any given time.



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