

## White Paper based on the 23<sup>rd</sup> October 2012 Panel Debate: “The Benefits and Risks of NED Independence”

Genius Methods would like to thank you for joining us and our esteemed [panel](#) on the 23<sup>rd</sup> of October at the Cavalry and Guards Club in London to discuss your key experiences and views in relation to the risks and benefits of NED independence.

There are highly polarised points of view on NED independence with valuable and negative impacts at both ends of the spectrum of NED independence or lack thereof. This paper presents the main discussion points and findings that arose from the evening’s work.

Chairman of Genius Methods, Alan Hindley’s view is that *“a key importance of NED independence is to provide an empowered “check and balance” position that fights group think, prevents “cliques” and protects unrepresented stakeholders.”*

### **NED Independence – setting the scene**

All directors, however, have the same responsibilities and should adhere to the same moral and ethical codes. The difference is that for Executive Directors wear ‘two hats’ which include both their executive and director responsibilities. NED’s do not have to juggle these dual-roles.

At UK and European levels, regulator and stakeholder attention on the Board is continually increasing. Directors and Boards as a whole are required to be more transparent than ever and to operate in increasingly complex, fast moving and open knowledge environments.

*“Boards used to operate in a Castle with a full moat and drawbridges up.*

*Now Boards operate naked, in glass houses”*

*Sharon Constançon, CEO Genius Methods*

With recent mindset shifts such as the ‘shareholder spring’, owners and stakeholders are making their voices heard and demanding accountability. Chairmen are concerned as to the impact these stakeholder expectations have on board composition, decision making and ultimately the open challenge by Non-Executive Directors.

*“The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company”*

*FRC – UK Corporate Governance Code*

*... ensuring better aligned behaviour (where there is a controlling shareholder)*

*... requiring a majority of independent directors on the board...*

*FSA – CP12/25*

## Debate – key messages

These are the summary of key messages from the panel, table discussions and responses in the Q & A session:

1. The UK shareholder demographics needs to be counterbalanced with an appropriate Board composition, improved stewardship efforts and respect given to the comply or explain, principled based governance code that allows companies to appropriately apply good governance.
2. The issues are probably less about independence and more about behaviour of the individual
3. More critical than independence itself, is the ability to challenge constructively, debate collectively and with the support of good management information, come to the best decisions in the long term interests of the company
4. Ethics and integrity are key character requirements for a NED who together should bring a diversity of skills and knowledge
5. No one model works for all companies, therefore, depending on the lifecycle, size, finance demands, networks and strategic objectives, different companies would want different types of NED's. The general view of the group was that smaller companies would need more dependent NED's and larger companies would tend to want independent NED's. The debate did consider that a mix on every Board would be ideal.
6. Highest risk of negative influence on decision making is caused by a misplaced "passion", which could be fuelled by a number of varying factors
7. Best practice and the shareholder spring were influencing the expected transparency of the activities in the Board room and a greater sharing of information with the investor and stakeholder communities
8. Concerns were raised on how a Board determines the existence of the correct behaviours in a prospect NED
9. The competent chairing skills of the Chairman were seen to be a key to effectively performing Board, irrespective of its composition
10. A Chairman's stance on ethics and accountability were key to encouraging optimum contribution by all Directors focusing on the long term vision and future outcomes in terms of behaviour and returns.

## Survey Results

A **poll** run by Genius Methods on LinkedIn indicated that 69% of respondents felt that total independence, in every meaning of the word was the most appropriate relationship for a NED, the next group indicated that a minor financial investment was appropriate.

A **survey** completed on assessing true independence of 60 NED's on 27 criteria indicated the following –

1. There was a majority with shareholding of between 5% and 25%
2. None had a past employee relationship with the company
3. Close on 25% had a past business relationship with the company
4. Around 10% had other earnings through pension, performance related earnings or share option incentives
5. Less than 10% had family or personal ties with the executives, senior management or other directors
6. Close on 10% had served more than 9 years
7. About 5% had other relationships with the company or industry
8. Each category reviewed reflected at least one director being totally independent
9. Two thirds of the categories had a director rated as being dependent in that category
10. Less than 25% of the Directors were truly independent

**DISCUSSION BY  
PANEL & PARTICIPANTS**

**Independence from what?**

When discussing director independence, what do we mean? What should NED's be independent from?

Concerns are based on the fact that humans make most decisions based on emotion and not on logic or facts alone.

*The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement.*

*FRC – UK Corporate Governance Code*

**The Code identifies the following factors as removing independence**

- a. Employee or third party business relationship with the company, or where there is income other than fees
- b. Investment in the business either as shareholder or financier
- c. Personal connection to any of the key individuals within the business or stakeholder groups
- d. Reliance on the income earned in the role
- e. Earning potential as either a supplier or customer of the business
- f. Been on the Board for more than nine years

**CONCLUSION**

**Independent from being influenced from independent thought in the process of debating, challenging and reaching a decision**

**Benefits of Independence**

The key expected governance benefit of 'independence' is that directors have more freedom to challenge the executives, the strategic plans and proposed actions that have significant impact on the business.

The focus of the Board is to protect the interests of shareholders and promote the long-term sustainability of the company. Independent directors are believed to be able to competently challenge a potential majority view and to challenge executives who are involved in the planning and operations.

Independence is believed to prevent group think, protect stakeholders, prevent fraud or undue preference and ensure risks are properly evaluated.

The typical example of independent behaviour expected of NED's is to temper the excitement, passion, drive of a plan that has traction but needs to be clearly reviewed from a distance to ensure viability of assumptions and outcomes. If high returns are forecasted, it is difficult for a NED, who will gain directly from the profit, to objectively view the appropriateness of the project within the strategic plan. The NED is too aligned with the passion of the executives.

### Benefits of Non-independence

The most frequently cited benefit of a “dependent NED” is that of having a vested interest and therefore being aligned with the executives.

“Dependent NED’s” may provide funding, industry knowledge, their network and related relationships. Investing directors are often likely, and expected, to give far more time for less fees given their future expected investment gain.

Many investors believe that investing NED’s are more likely to provide a “longer term” view and be more committed to the company’s success.

### Risks

The risk most frequently voiced is related to “behaviour”, the risk of being unduly influenced and not being able to be impartial, objective and focused on what is best for the business.

In the experience of CEO of Genius Methods, Sharon Constançon’s work with Boards, another high risk to Board effectiveness is an ineffective Chairman. *“Unfortunately there is limited training to help the leader CEO morph to being an effective Chairman and leader of the Board.”*

### Independence of Mind

*“The ability to act with integrity, exercise objectivity and professional challenge in order to provide an opinion without being subject to influences from business units that could impair professional judgement.”*

*FSA Paper on Operational Risk*

The fact that all directors have the same responsibilities raises the concept that independence is a function of the character of an individual not only the relationship to the company. A director may be independent on paper but ‘true’ independence is a quality, approach and professionalism deployed by an individual when working towards a decision. There are various factors which can either strengthen or weaken these qualities in a director:

Weaken	Strengthen
<ul style="list-style-type: none"> <li>i. Large shareholding</li> <li>ii. Pay related to short term performance</li> <li>iii. Personal relationships with other Board members or key stakeholders</li> <li>iv. Share options</li> <li>v. Poor chairmanship</li> <li>vi. Dysfunctional Board</li> <li>vii. Emotional reference points that are either skewed or not aligned</li> <li>viii. Ethical misalignment</li> </ul>	<ul style="list-style-type: none"> <li>i. Emotional commitment to the company’s purpose</li> <li>ii. Support and appreciation from other Board members and ability to work as a team</li> <li>iii. Good Chairmanship</li> <li>iv. Knowledge of the role, industry, issue, risks and opportunities</li> <li>v. Feedback</li> <li>vi. Passion for success in a risk balanced manner</li> <li>vii. Diversity of thought and debate</li> <li>viii. High personal ethical and moral standards</li> </ul>

**Another perspective discussed was  
Emotional entanglement versus Emotional Intelligence**

## Qualities demanded of a NED

Bijan Segdi, lawyer, industrialist, publisher and investor, a man who has experience of working with people and Boards, believes that *“it is the human qualities that are more important than the issue of whether the individual’s ties to the company are too close.”*

Bijan believes that the five “I’s” cover the required behaviour that make a NED valuable to the Board (See alongside). For Bijan, Investment Value is the creative investment by the NED in the company.

### The Five “I’s”

Integrity  
Independence  
Instincts  
Innovation  
Investment Value

## Measuring Independence

Research, the group and regulator comments allude to “true” independence being a quality displayed by the directors, therefore making independence difficult to measure.

### Additional values and sought of NED’s, believed to be more likely to be found in independent NED’s ....

- i. Constructive and independent challenge
- ii. Quality and professional motivation
- iii. Vision and independent long term clarity
- iv. Risk maturity, understand corporate risk
- v. Resilience and time when needed in crisis

### Expected outcomes of independent NED’s

- vi. Improve Board judgement
- vii. Tame eccentric or over zealous behaviour
- viii. Support creation of an effective Board

Nomination Committees and the search industry need to mature to reach a level where they interview to fill a skills gap on the Board but simultaneously address desired independent behaviours fit to create constructive tension. This is not easily achieved.

The industry is maturing in its efforts to assess prospective NED’s more effectively. Given that “personality” combined with “experience” are the key drivers and indicators of “future behaviour”, some Boards are now turning to psychometric tools to gain a more impartial prediction of how “independent”, “steadfast” and “influential” etc., potential NEDs and Board members are likely to be.

David Howells of Kiddy International says *“...impartial prediction of how “independent”, “steadfast” and “influential” etc. a director will be are characteristics that are measureable and are comprised of well-established traits within the realm of psychometric evaluation.”*

## Could ‘skin in the game’ ever be a good thing?

There was a view that it might be beneficial for owners if directors did have personal interests which were aligned with shareholders. This can be created through financial incentives including share options.

In a public listed company, even a one share investment means that a NED can see exactly what is sent to shareholders, attend an AGM and get a sense of how stakeholders are being treated. NEDs holding shares can also be seen as a 'vote of confidence' in the company.

Some believe that having 'skin in the game' creates an emotional response and an incentive to over focus on company profitability only that 'total independence' is less likely to foster. The cost is a risk of short term thinking and focus on only one stakeholder group.

Constançon's view is *"An effective Board needs a balance of executive and non-executive, the latter being the majority and within this group, the larger number being truly independent by every measure. This creates a diversity of thought."*

### **Different Board / Stakeholder models seen in Europe**

#### **a. The "Swedish Model"**

Works in an environment where there are fewer shareholders with larger percentages investments and therefore greater shareholder engagement. A unitary Board structure but with only one Executive (CEO) on the Board and NED's are appointed by the shareholders who make up the Nominations Committee. There is additional focus on attributes and behaviours in addition to skills.

UK NED, Bob Beveridge states *"Without adopting the Swedish model, I hope that UK companies will find ways to gain greater shareholder engagement in the ever important nomination process."*

#### **b. The "German Model"**

A dual Board structure with a supervisory board, led by the Chairman which is responsible for appointment, governance and supervision of the management Board. The management Board, led by the CEO is responsible for running the company. The structure is designed to prevent skewing of power which is further enforced by the CEO and Chairman not being the same person.

### **Tone from the Top**

*Tone from the Top is vital in developing and maintaining the ethical integrity of the business. Without it, the ability to mitigate the risk of something going wrong is significantly impaired.*

*PwC Survey*

Tone at the Top is about creating a culture where everyone has ownership and responsibility for doing the right thing, because it is the right thing to do. This needs to be practised, communicated, monitored, rewarded and controlled. The behaviours desired should be "business as usual".

UK NED, Professor Bryan Foss states that *"as the rate of business change increases, strong leadership skills are required yet we have entered a period where NED terms will be shorter and stakeholder demands are higher."*

### **CONCLUSION**

**There is NO one answer that applies to all entities.**

**Each company needs to determine what it requires to get robust diversity, challenge, professionalism, skills and risk maturity to lead and direct the company effectively.**