

THE ROLE OF THE CHAIRMAN

This report, derived from interviews with Chairmen, CEOs and Advisors, gives an overview of the role of the Chairman as it is seen today; with the Chairman, the CEO and the board under more pressure than ever before to perform well; with time scales shortened and less tolerance of under-performance; and with an aggressive media and more active shareholders.

Who'd want to be a Chairman?



1. The Changing Role of the Chairman
2. Independence
3. The Chairman CEO relationship
4. Executives on the board
5. Succession
6. Non-executive directors
7. Board committees
8. Strategy
9. Shareholders
10. Board evaluation
11. Governance and the Combined Code

“The one bit of regulation of control of human behaviour that really has worked in the Stock Exchange is the Takeover Code, which is not a list of highly detailed prescriptive rules but actually starts out with principles which then get down into rules.”

INTRODUCTION

One of the substantive changes currently taking place is greater professionalism in the running of boards. Annual board reviews and appraisals are now with us, and are set to become more onerous and invasive. Previously, a large numbers of boards did not have any proper professional basis for recruitment; they had no proper performance evaluation; the chairman's performance was hardly ever looked at; and individual board members were hardly ever reviewed. Now, all of those things will fall to the Chairman. For many, this will mean a whole new way of working and a significant increase in time commitment. This white paper has been compiled to help you understand and review your role as a Chairman.

1. THE CHANGING ROLE OF THE CHAIRMAN

The Chairman's role, in UK companies, has undergone significant change recently, due in part to new recommendations in the Higgs Report (2003) and the provisions of the Combined Code on Corporate Governance (2003). However, the chairman's primary role still is to focus on maximising the value to be had from the board, individual directors and committees, while ensuring that the company has adequate governance. It is also important that the chairman finds the right balance between value creation and the bureaucracy of governance; otherwise the former easily gets stifled.

"The Chairman's' principle job is to run the board effectively: to provide the right balance within the board room..."

How much time a Chairman should devote to his role is a widely contrasting opinion, ranging from a day a week to three days plus additional time to manage crises. However, these days, more and more time is spent on governance than ever before, focusing on assessing risks and making sure the company is covered for that risk. As chairman, you cannot pay lip service to governance, you have to plan board succession and worry about the external perception of the governance of the company.

Today, greater professionalism is expected of a Chairman. S/he must possess a range of 'soft skills' and have the ability to coach new board members (especially executive directors); handle debates with skill; tease out concerns; orchestrate and unite an often disparate group; recruit the right people; and effect behavioural change where necessary. The chairman needs to make sure that certain topics are raised and put on the agenda at board meetings and that he has frequent contact with the non-executives to hear their concerns. In addition, the Chairman must act as a bridge between executives and non-executives despite the tendency for governance to push them apart; avoid the temptation to interfere; be familiar with the current issues; and be widely accessible to the board members and the shareholder community. On the whole, the Chairman's role should be played in the background.

"Sometimes, you've got to let the nerve be touched, probed and explored."

The division of responsibilities between the Chairman and the CEO is an important issue and should be ground out at the outset of the relationship. The role of the Chairman is clearly to run the board; to challenge the CEO; to make sure the right CEO is in place, otherwise to fire him; to make sure the company is on the right track; and to deal with people on the board.

In a nutshell, the Chairman's primary role is to run an effective board, allowing the CEO space to run the company.

2. INDEPENDENCE

The new Combined Code makes a distinction between the chairman and non-executives in terms of their independence: the chairman should be deemed independent at the time of appointment, but not thereafter. Today, the responsible chairman is likely to spend more time in the business than in the past and be more engaged with the issues and the people. Consequently, he is not independent in the sense that non-executives are considered independent, being less involved day-to-day.

Nevertheless, a good chairman is perfectly capable of behaving independently of management when it comes to orchestrating debate, scrutinising performance, reviewing financials, evaluating potential hires and conducting other key tasks. The chairman should not come from management nor be part of it. That's the essential element. Chairman should have the experience and financial and intellectual substance to put their positions at risk if they feel there are developments within the company that make them uncomfortable or are not in the shareholders interest.

“The CEO's role is a lonely one, and so there needs to be a strong relationship with the Chairman, so that he or she can unburden himself or herself completely.”

3. THE CHAIRMAN-CEO RELATIONSHIP

Without doubt, the quality of the Chairman-CEO relationship is a major factor in determining the success of the board, providing a solid foundation from which the CEO can direct the company's fortunes. Many CEOs express the isolation, even loneliness, of their role: unable to confide fully in executive colleagues and subject to intense scrutiny from shareholders and the media. The CEO needs a supportive Chairman who can be a confidant, sounding board and sparring partner.

The relationship between the chairman and chief executive is dependent on personalities and relationships, and therefore rigidly defined templates are inappropriate. But it does make good sense to define the boundaries of each role – to keep the lines of authority clear, ensuring clarity in the eyes of both the board and the outside world. The Chairman and the

CEO have to be very close. It's a personal relationship – what matters is how you communicate and relate to each other. Of course, having clarity on the strategy is critical.

“The CEO is running the company, and that's the way it should be”

The nature of the CEO's job and the exposure that goes with it has changed; it's a lonelier place than it has ever been. Today, there is a sort of a coaching, mentoring, supporting aspect to being a Chairman which is probably more important than it was even five years ago. The Chairman, above all, should be more sensitive to the realities of the baggage that goes with being a CEO these days.

4. EXECUTIVES ON THE BOARD

A board member's responsibilities are quite distinct from those of an executive and it is not uncommon for executives to feel under the shadow of the CEO, unsure how, or whether, to speak their minds. But, these executive board members have the same legal responsibility as anyone else around the table, and know more about the business than most, so they should be encouraged to voice their opinions. The Chairman clearly has an important role in building the trust that will result in all executive directors participating fully in the board's affairs.

One way to ensure there are enough 'heads' to create good debate and objectivity could be where a range of executives attend board meetings without formally assuming board director status. This would expose executives to board discussion and non-executive scrutiny without burdening them with the legal and fiduciary responsibilities of the director (to be “in the boardroom, but not on the board”). It is hugely beneficial for executives to have exposure to non-executive pressure. It gives an edge to their performance. However, this becomes a two-tier approach that may not work as it does not encourage the concept of shared responsibility which is so essential to board dynamics.

The more executives there are, the more non-executives need to be appointed; boards become bigger and it gets more difficult to govern the company. Audit and risk representation needs to be quite hefty because the burden of responsibility is heavy and cannot be only a couple of committee members, but four or five. However, excessive board size can inhibit effective discussion; if the size of the group swells dramatically, board discussion is likely to be adversely affected. Therefore, there is a trend to try to keep boards smaller if at all possible.

“There is more attention being paid to this – call it ‘soft stuff’ – than before, because (a) people are more aware of it, and (b) compliance with the Higgs process actually requires them to devote some time to these softer issues.”

There are opinions about whether governance pressures are gradually shifting UK boards closer to the American model where the CEO and CFO are the only executive members of the board. Also, recommendations in the Higgs Report suggest that non-executives should make up the majority of a board. However, the UK’s current “collegiate” system seems to offer the right kind of structure in which frank and open debate can take place (although, as noted elsewhere, the Chairman plays a key role in ensuring that the right atmosphere exists for such discussion). The counter-argument, that executives should be in the majority, is on the grounds that the ultimate decision-makers should be those running the business.

However, the Chairman should ensure there is a strong executive presence on boards. It would unbalance governance and unbalance the way companies with a duo or even just a single executive. The unitary board is a college and remains the supreme focus of governance of the business: not to have a strong executive representation distorts the board.

5. SUCCESSION



The Chairman’s role in succession is huge. The chairman has to make sure that the CEO has the right processes in place, that he’s building talent and that the company is taking a long-term view regarding people. The board has to understand that continuity matters and that interest in succession should be at a level or two below the board.

“There should be an apprentice on every board, in my view.”

There is a duty on the board to ensure that there is good succession in place internally; making sure there are adequate internal candidates and developing them towards a board position. It could well be that the company needs a shake up, and the culture and the direction of the company need changing, in which case only then should external candidates be considered.

Attention to succession is probably one of the more positive developments over the last couple of years to come out of recommendations, not just for the CEO but also for other key jobs in the organisation. The chairman should have interaction with the top 20 individuals in the company, so when there is a conversation about promoting a person the chairman should know the individual and should not need to be introduced.

6. NON-EXECUTIVE DIRECTORS

The role of the non-executive director has certainly changed since publication of the Higgs Report. Given the increased interest in board composition and effectiveness, director independence and the issue of liability, it almost goes without saying that the duties and responsibilities of non-executives are at a different level than they were even five years ago. Non-executives are expected to commit more time and to pull their weight; to demonstrate a more rigorous understanding of the business and engage more deeply with the issues facing the company. They are in the spotlight like never before. There are no sinecures on the boards of major companies, and Chairmen are spending more time and effort coaxing contributions out of fellow directors.

Many Chairmen experience difficulties, or expect to in the future, attracting first-rate people onto their boards; a problem that is exacerbated when it comes to finding people to chair or sit on audit committees. Nowadays, there is a genuine concern that the risks of directorship far outweigh the benefits and that there is less and less to attract new people into non-executive positions.

The overall time commitment for any non-exec is increasing and the focus is more on covering one's back. That will make it more difficult to attract quality non-executives, since a) people can take on fewer roles due to the increased time commitment, and b) many people are simply opting out of the whole process and saying it's just not worth it. Also, one's time gets increasingly skewed towards governance rather than business, which makes the job of a non-executive less interesting.

People who really do understand the company and markets are very important as board members. However, corporate memory is an extremely important feature of any board and therefore longevity of non-executives is paramount. New people on the board bring fresh insights, but very often ask the question: 'how did we get here?' The older hands on the board know precisely how 'we' got there, and where the bodies are buried.

“There is a real danger of losing invaluable experience.”

The role of the Chairman in regard to non-executive directors is becoming increasingly more difficult. Trying to recruit on to a board from a pool of largely unwilling candidates will be a genuine challenge. And, having recruited to the board, keeping these new recruits engaged for 8-10 years will be a key role.

7. BOARD COMMITTEES

Many key tasks are delegated to board committees that are treated with ever greater seriousness. The remits of the three main committees are dealt with at length in the Higgs Report and Smith Guidance (in the case of audit), and do not need elaboration here. Suffice it to say that a significant part of the chairman’s role involves supervision of committee work and the careful deployment (and rotation) of non-executives on to committees, which can number as many as five or six in some companies.

Nomination committee

Generally, there is unanimous support for the Chairman of the board acting as Chairman of the nomination committee, given that it is extremely difficult for the chairman to achieve the “magic balance” of people otherwise. The composition of the board is still clearly considered to be the Chairman’s prerogative. There is also general approval for the broadening of the nomination committee’s remit to include succession for the board and executives and the review of management performance and board effectiveness.

Audit committee

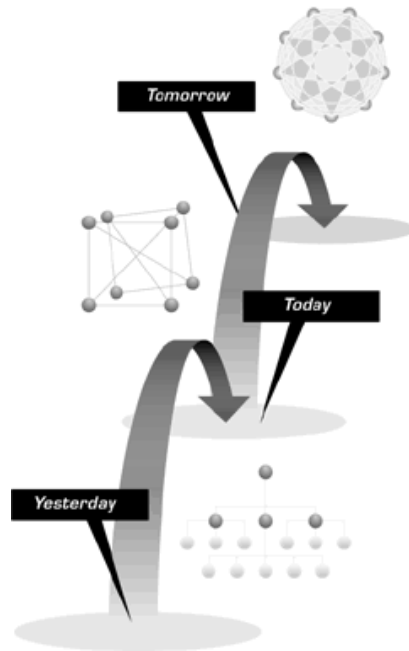
Research demonstrates that there are strong feelings that Chairmen should not be present at every audit committee meeting, pointing out the importance of delegating to a strong audit committee chairman.

Remuneration committee

Research also finds the prevailing view that the board Chairman should attend the remuneration committee and be fully engaged in the debate on CEO and senior executive pay. The remuneration committee sets the performance hurdles which drive management targets. To exclude the Chairman from influencing these levers, on the basis of his lack of independence, is considered wrong. Board Chairmen should expect, at the very least, to receive all papers that go to committees in order to know where the contentious issues are, and to be consulted prior to any major decisions being made.

“There clearly is a shortage of high calibre executives who actually want to be chairmen.”

8. STRATEGY



Chairmen are increasingly focusing on strategy, following two years of governance-dominated boardroom agendas. “Strategy away days” are a critical forum for frank, open discussion between executives and non-executives over the full gamut of strategic options for the business.

The development and prosecution of strategy is the chief executive’s prerogative with the executive team. For the chairman to be actively involved in developing strategy is to step over the line. The Chairman’s role, however, is to ensure that the ideas and plans are submitted to proper scrutiny and that all views are aired. He should act as a sounding board for the CEO, rather than as an initiator of strategy. The CEO needs a sounding board and the Chairman is there to challenge the CEO with his personal opinion and that of his colleagues. He must make sure that the right points are discussed and that the agenda is focused on the long-term vitality of the company.

“For the chairman to be actively involved in developing strategy is to step over the line.”

If the board is run properly, strategy should be more or less permanently in the frame. Discussion of strategy should be a continuous, fluid process. As leader of the board, the Chairman’s role in strategy is a difference of degree, not of substance. He has a particular responsibility to keep strategic issues at the front of the agenda. This means ensuring that the board really understands what the strategy means and implies, what it requires in the form of resources, and then making sure the executive as a group, and the chief executive in particular, can deliver.

Also, the Chairman’s role is to try to build as much of a consensus as he can among the board members. If there is something contentious, particularly aggressive or out of line with the dynamics of the company at the time, then clearly the CEO should square that with the chairman and seek his or her support for it before it is presented to the board.

“Business strategy is a pretty professional sort of area these days, so if you’re going to get involved in the strategy you’ve got to do so properly. Having lots of gifted amateurs floating about is very dangerous.”

9. SHAREHOLDERS

The CEO, CFO and head of investor relations should be handling day-to-day communications with investors, since they are in the best position to explain financials, answer operational questions and provide detail on strategy. The splitting of roles at the top of listed companies has resulted in Chairmen having far less contact with shareholders since the Cadbury Report. Today, contact between companies and shareholders is more structured and formal. However, Chairmen still need to have a rapport with major investors, making themselves available to listen to investor concerns and answer questions that fall within the Chairman’s remit. A Chairman who does not already have a rapport with key shareholders must cultivate a relationship in order to be able draw on it as difficulties arise. Waiting until crisis point before trying to establish a relationship will invariably be too late.

One of the unintended side effects of the separation of the chairman and chief executive role is that most chairmen delegate contact with shareholders/analysts entirely to their chief executive and finance director. Chairmen have generally become too distanced from shareholders. The Chairman has to be available to the shareholders, and a good Chairman makes a point of meeting the major shareholders from time to time. There needs to be a relationship in the sense that shareholders feel they know the chairman, they’ve seen him face to face, they know who he is and they’ve got access if they want to talk to him. Listen to what shareholders think of your strategy, performance, governance issues, and so on – to make them feel that they can always address the Chairman if they have any issues. As a chairman you need to know who your major shareholders are, more than just the name of the institution. You need to have two points of contact with an institution. But if things are going well, which they are in the vast majority of cases, the shareholders will limit their contact to the CEO, the CFO and the head of investor relations.

“You need to have highly structured meetings with shareholders.”

A consistent source of frustration for Chairmen is the lack of shareholder interest in holding meetings. Many express their frustration at the way fund managers and their colleagues in governance/compliance rarely attend meetings together. Since questions for Chairmen invariably revolve around governance issues, with which fund managers tend not to be actively engaged, it would make sense for institutional investors to take a more “joined up” approach to their contact with board representatives.

10. BOARD EVALUATION

The principle of performance evaluation is considered of fundamental value and importance for a healthy board. However, there are a range of views on the best way to approach the provision set out in the Combined Code that “the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.” The provision requires the company to state in its annual report how performance evaluation has been conducted.

Considerable attention is being focused on evaluation, not least because of the amount of scrutiny that can be expected over this element of the board’s activities. However, evaluation techniques are still in their infancy. Currently, the Combined Code is not very prescriptive about methodology and recognises that boards may take some time to develop an approach to evaluation that best suits their circumstances and membership. Over a period of time, however, the board effectiveness review will definitely become more incisive, more invasive, more structured. As yet it is nowhere near as structured as the evaluation of individual executive performance within a company. Basically, the higher up the company, the more vague we are around the core competencies required and how people have performed.

The role of the Chairman may well be as a facilitator of an internal review where with the company secretary plays a key role in administering questionnaires, collating feedback and sometimes conducting face-to-face interviews. 360 degree appraisals can also be used in some instances, although it risks leaving difficult issues, especially around the chairman, unspoken. Of course, some chairmen may be tempted to manage the review process internally in order to keep control and manage the situation themselves.

Employing a third-party, such as an external consultant, is often the best approach to performance evaluation due to the objectivity and credibility that outsiders can bring, not least as a means of satisfying shareholders that an independent review has been carried out. Perhaps the best way of doing this is as a “facilitated self-evaluation”: a moderated process preserving anonymity for the participant and encouraging feedback. However, this needs to

be weighed against the time needed to brief the external consultant of the issues and personalities to a level that could result in real insights and positive outcomes.

“People are nervous and uncomfortable evaluating colleagues on the board. Somehow or other they look upon meetings around the board as in some way different from when they meet in their executive capacity. They have a sort of willing suspension of disbelief about the fact that you should have the same standards.”

The most important thing is that it happens in an objective way that can be documented. Whether evaluations are managed externally or internally, they should be led by the Chairman, whose responsibility it is to report back on the issues collectively with the board and individually with directors. It is unlikely that a full and thorough externally-led board evaluation will happen on an annual basis, partly because of the time implications and partly, on a stable board at least, due to the law of diminishing returns. However, alternating full board evaluation with committee evaluations (bringing in specialist audit expertise, for example) may be a viable approach, although The Combined Code does call for “formal and rigorous” evaluation of the board, directors and committees on an annual basis. How thoroughly chairmen will choose to comply with this provision remains to be seen.

“At the moment it’s being handled with a degree of timidity, with many boards evaluating themselves rather than using external consultants.”

The key thing about the whole process is: does the board learn as a consequence of carrying out a full effectiveness review? That requires you to talk about the competencies you need around the board table: how the board operates; is it looking at the right issues; can it look back with confidence over the year and say ‘we as a board, as opposed to we as a company, had a good year; did we handle figures well; what did we not handle well and what lessons could be learnt from that?’

As a matter of etiquette, it is right and proper that the Chairman should speak to all the directors individually about their assessment of the board and about the contribution of individual directors. To the extent that a consensus begins to emerge, it should be fed back to the individual director.

11. GOVERNANCE AND THE COMBINED CODE

The July 2003 Combined Code, which derived from the Higgs and Smith reports published in January that year, has undoubtedly had a significant impact on corporate governance practices in the U.K.'s leading companies. Although many aspects of the new Code have been accepted quite happily, some of its provisions have caused a great deal of consternation. What follows is a miscellany of observations from the interviewees on some of these governance issues.

"Governance is about setting in place the structure to manage risks so you can then get on with running the business and sleep easy at night. Those people who see governance as something extraneous, all about compliance and rules that they don't really understand and don't see the point of, are precisely the people who will mess it up, have difficulty with shareholders and resent shareholder activism." *Advisor*

"Being able to point to the guidelines is helpful in terms of pushing through change on some of what one might call the less enlightened or more historically run boards. What becomes slightly tedious is the way in which the code then tends to be used as a checklist – are they doing this or aren't they doing this?" *Chairman*

"Those people who see governance as something extraneous, all about compliance and rules that they don't really understand and don't see the point of, are precisely the people who will mess it up,,,"

"The responsibility on non-execs to sign off statements about the future of the company and the individuals' need to protect themselves can drive a wedge between the execs and the non-execs. One of the dangers of governance is that you can almost forget that the prime objective is wealth creation. The balance between wealth creation and governance is out of kilter at the moment." *Chairman*

"There's no doubt that boards spend more time on governance-related issues, risk assessment and so on. If you're not careful other agenda items get squeezed out. The answer to that is to increase the amount of time available. To me, the essential thing is to try and make sure that you've handled the governance side efficiently, not perfunctorily. We need constructive, not bureaucratic, governance." *Chairman*

CONCLUSION

Without a doubt, the bureaucratic burden of being a company in the Financial Services industry is increasing exponentially here in the UK. Business is about competing in market places, beating competitors and serving customers – not about endless bureaucracy. Many Chairmen believe that complying fully with all of these government guidelines, even though there are some positive benefits, will reduce the amount of time that the leadership of the company is spending on value creation. After all, Governance is not something which most business leaders are really very interested in.

“... nor do I think that you can assume that there is only one model for human behaviour. It's rather like trying to produce a manual for how somebody should or shouldn't fall in love. It's ridiculous; it either does or doesn't happen.”

Summarised by Dr. Deborah Swallow from extensive research by Jan Hall and Alastair Rolfe (2005): 'The role of the FTSE 100 Chairman' interviews with chairmen, CEOs and advisors.

Dr. Swallow is Business Development Director for Corporate Training Partnerships Ltd with special responsibility for the Business Management Academy and the Management Development Programmes of the company.