# Guiding Principles for an Effective Board

## Insights from Engagement

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# Executive Summary

Investors care deeply about how well a company board is functioning. Getting this aspect of governance right makes it more likely that material risks and opportunities will be well managed. It follows that an effective board is best placed to secure a company's long-term success.

Yet it remains difficult to assess the effectiveness of a board. Disclosure on the measurable aspects of boards, such as the size of the board, the age and tenure of directors, and the level of meeting attendance, is improving in some markets. While we welcome these developments, we are concerned that the set of standardised data points provided in company disclosures offer a limited picture of a board's functionality. Ticking all the "good governance" boxes does not necessarily translate into good governance, as demonstrated by continuing large-scale corporate failures.

Engagement between investors and board directors provides a valuable opportunity to more deeply assess how well a board is functioning. This paper highlights the factors that we consider to be most important in determining board effectiveness. Our insights have been informed by engagement with directors from a wide range of sectors, markets and structures of corporate control.

There are two broad categories of a board's characteristics: quantitative aspects that are easy to assess and qualitative aspects that are more difficult to assess. We conceptualise these two distinct categories as a board's "hardware" and "software". This paper focuses on a board's software, which relates to the human, relational, and behavioural elements of a board. These aspects can only be explored through meaningful engagement between investors and board directors. The five principles articulated in this paper are highlighted below.

> **Directors should have diverse characteristics, perspectives and approaches, including diverse personality types. Genuine diversity and inclusion improve the quality of debate and decision-making on a board.**

### 1. Genuine independence, diversity and inclusion

Independent directors must have the psychological capabilities, emotional intelligence and experience to effectively question long-held assumptions and mitigate the risk of groupthink. Directors should have diverse characteristics, perspectives and approaches, including diverse personality types. Genuine diversity and inclusion improve the quality of debate and decision-making on a board. The skill sets of directors must reflect the company's strategic priorities, with directors taking personal responsibility for continuous learning and development.

### 2. The role of the chair

An independent chair is best placed to create the overall conditions for board effectiveness. The chair must set and enforce the expectations for a board culture that is based on mutual respect, openness and trust. Diverse voices and behaviours of independent thinkers must be actively encouraged by the chair in order to create a healthy tension on the board.

### 3. How the board allocates its time

A board must maximise the time spent on strategy and other forward-looking activities, finding a way to prioritise the important but non-urgent matters. The structure of the board agenda and the information flow to the board must reflect its priorities. The time spent between board meetings is equally important and should include committee work, site visits and engagement with key stakeholders.

### 4. The board's relationship with the CEO

It is critical that the chair and CEO roles are held separately. The relationship between the board and the CEO should ideally be characterised by transparency, trust and constructive collaboration. The board should also build relationships with the wider workforce through formal and informal channels.

### 5. A commitment to continuous improvement

Board evaluations are a valuable tool for assessing and improving a board's effectiveness, though only when directors are committed to the process. Disclosure should strike a fine balance between providing reassurance to investors and maintaining confidentially.

# Introduction

Boards are structures through which individuals come together to act in the best interests of a company and its shareholders. As with all groups of people, boards contain inherent biases and complex dynamics that can be acknowledged and mitigated, but not eliminated. This paper outlines the key characteristics of boards that we consider to be well positioned to conduct their duties. Our goal is to move beyond the traditional indicators of board effectiveness to the less tangible, yet crucial, aspects. Many of the latter aspects can only be understood and assessed through direct engagement between investors and board directors.

Unsurprisingly, there is no blueprint for a perfect board. The subject has attracted considerable academic and industry attention; a vast body of research has offered valuable insights and consistently demonstrated that there is no one-size-fits-all model[1]. There is some degree of consensus about components that signal an effective board. For instance, strong diversity, high independence, and separate chair and CEO roles are widely considered to improve board functionality[2]. Conversely, boards with directors who are over-committed or regularly miss meetings raise concerns. There is a growing consensus that boards that focus on a company's strategy and long-term value creation outperform boards that are driven by short-term pressures[3].

The debate about how boards should spend their time is particularly pertinent in the current political and legislative context. Across markets, directors are increasingly expected to take on responsibility for a greater range of issues and to become accountable to a broader set of stakeholders[4].

Nowadays, environmental and social issues are commonly considered to be part of a board's remit, capturing an array of issues from data privacy to climate change, from corporate culture to antimicrobial resistance. Simultaneously, regulatory expectations have become more complex and demanding, which has created a tension: the pressure for a board to spend more time on strategic matters is at odds with the greater time required to complete compliance activities.

To effectively carry out their stewardship role, it is important for investors to understand the specific challenges facing a board. Over the last decade, there has been an industry-wide push for more standardised data on corporate governance. This trend has enabled easier comparisons between company boards on some quantifiable characteristics. However, it has also led to a risk of "governance by numbers", meaning that boxes are ticked but board effectiveness is not guaranteed.

Empirical research shows that some indicators that are commonly used in assessments of corporate governance – including the presence of a lead independent director and the number of board meetings – have limited ability to explain organisational performance[5]. By reviewing public disclosures, which provide only a partial snapshot of board activity, investors can be lured into a false sense of security, especially when there are no obvious red flags.

The information gap can be addressed though engagement. Thoughtful dialogue between investors and board directors enables a deeper understanding of a board's characteristics, strengths and weaknesses. Trusting and transparent relationships enable areas for improvement to be identified and addressed within a framework of accountability. This paper will outline five guiding principles for a board, as informed by our engagement with board directors and management teams.

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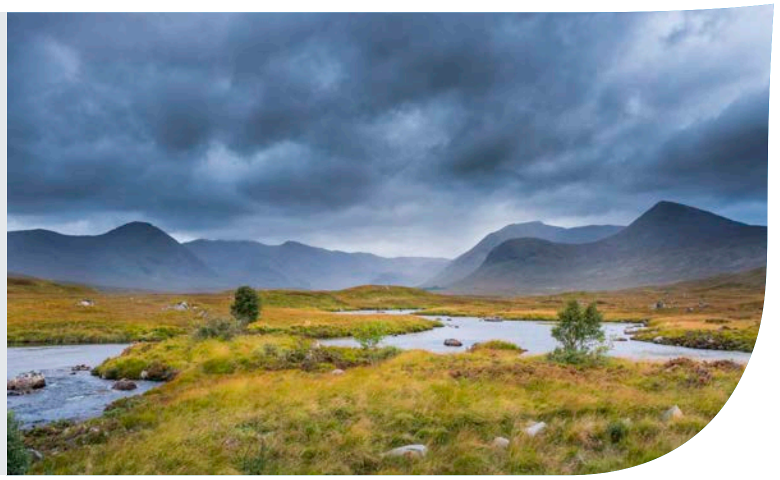



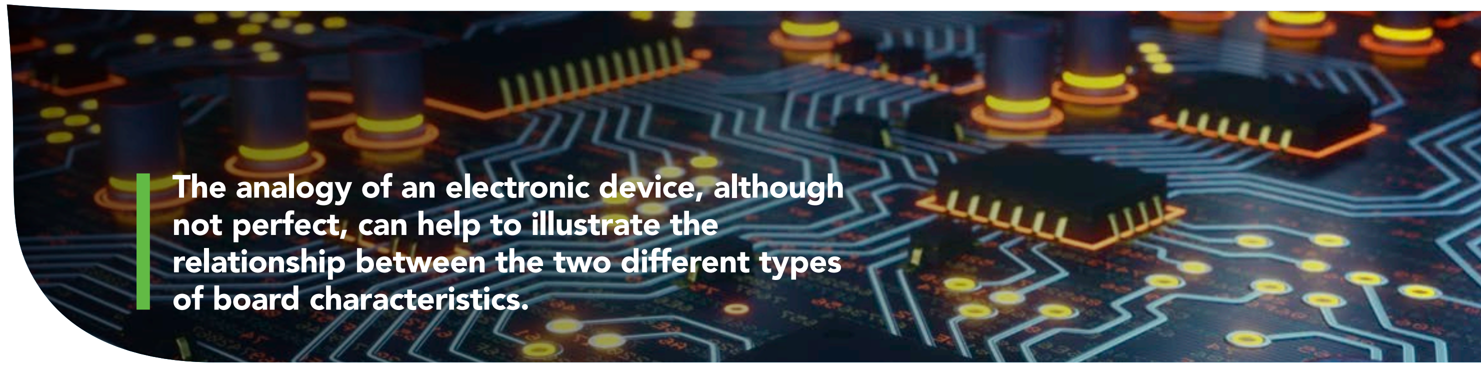

**The analogy of an electronic device, although not perfect, can help to illustrate the relationship between the two different types of board characteristics.**

# A board's hardware and software

The characteristics of a board can be separated into two broad categories: characteristics that are easily assessed and those that are more difficult to assess. The categories can also be thought of as quantitative versus qualitative.

In general, a company's public disclosure on governance matters focuses on the characteristics that are easily assessed and quantifiable. However, investors cannot comprehensively assess the quality of governance at a company by relying on these limited data points. Our view is that good governance is much more nuanced and complex. Given the subjective nature of the second set of characteristics – those that are difficult to assess and qualitative – they should be explored through meaningful engagement between investors and board directors.

The analogy of an electronic device, although not perfect, can help to illustrate the relationship between the two different types of board characteristics. Consider a computer, which is composed of hardware and software. The hardware consists of physical devices, including the monitor, keyboard, and mouse. The software is the programmes that run on the hardware. Crucially, the device will only function properly with the right combination of hardware and software.

A similar arrangement appears within a board: the "hardware" is a set of structural board characteristics that can be easily measured and disclosed, while the "software" reflects the human, relational, and behavioural elements of a board, which are inherently more difficult to measure. The two aspects are interdependent, enabling the board to effectively conduct its duties when the hardware and software are complementary.

Figure 1 overleaf illustrates how we have conceptualised the difference between a board's hardware and software. Although the characteristics covered in each of the two categories are not exhaustive, they highlight the important distinction between those aspects that can be easily captured by data points versus those aspects that require deeper interrogation.

Hardware includes the size of the board, the frequency of board meetings, and the committees established. The existence of specific roles, such as the senior independent director and the board secretary, as well as board diversity according to measurable characteristics, also constitute the board's hardware.

Meanwhile, software captures aspects such as board dynamics and culture, how board directors interact with the CEO and the wider workforce, and the diversity of thought on the board. Behavioural and psychological aspects are critical components of the software. Independence, though commonly assessed by tenure and former relationships, is a subjective judgement that falls into the software category when referring to the ability of independent directors to fulfil their role. A board evaluation sits above both the hardware and the software, testing functionality in the same way that an electronic device undergoes regular testing and improvement.

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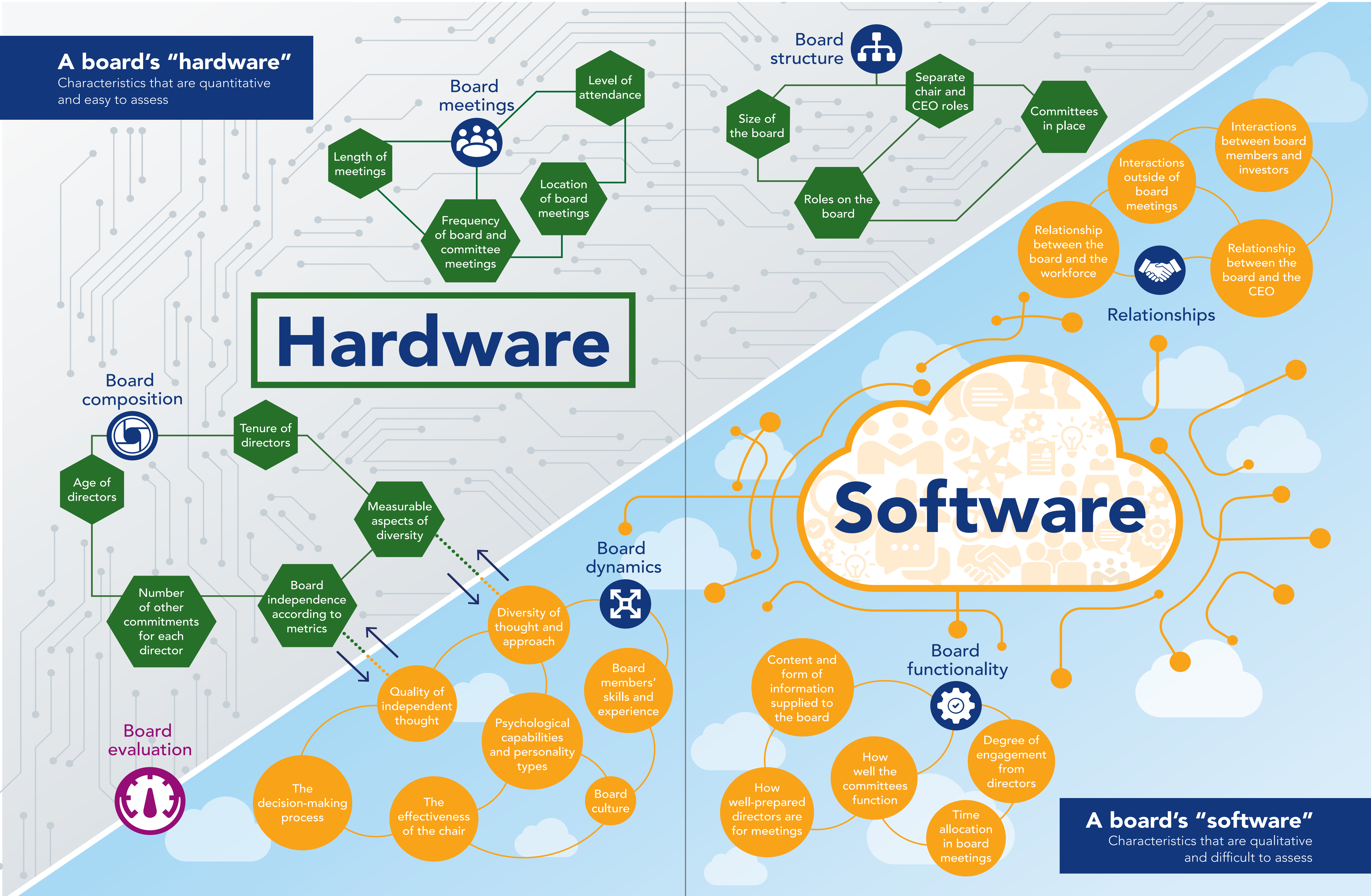
This paper will focus largely on a board's software, namely the qualitative aspects of a board that are difficult to measure. Our thinking has been informed by engagement with board directors and management teams across different countries and structures of corporate control. As the theoretical and practical thinking about governance continually evolves, we do not claim to have all the answers. However, we hope that the five guiding principles outlined in this paper offer an insight into where boards may wish to focus in order to enhance the quality of corporate governance.

Figure 1


A board's "hardware"
Characteristics that are quantitative and easy to assess
Hardware
Board meetings
Level of attendance
Length of meetings
Location of board meetings
Frequency of board and committee meetings
Board structure
Separate chair and CEO roles
Size of the board
Committees in place
Roles on the board
Board composition
Tenure of directors
Age of directors
Measurable aspects of diversity
Number of other commitments for each director
Board independence according to metrics
Board evaluation
Board dynamics
Diversity of thought and approach
Quality of independent thought
Board members' skills and experience
Psychological capabilities and personality types
Board culture
The decision-making process
The effectiveness of the chair
Software
Relationships
Interactions between board members and investors
Interactions outside of board meetings
Relationship between the board and the workforce
Relationship between the board and the CEO
Board functionality
Content and form of information supplied to the board
Degree of engagement from directors
How well the committees function
How well-prepared directors are for meetings
Time allocation in board meetings
A board's "software"
Characteristics that are qualitative and difficult to assess

# Different structures of corporate control

The primary reason why a board cannot follow a simple rule book to improve effectiveness is that the requirements and possibilities will differ depending on the corporate control structure. The type of structure is likely to have implications for both the hardware and software of a board, as well as the opportunities for engagement between investors and board directors.

The most common control structures are outlined in Figure 2[6]. While there are some regional trends, the different structures cannot be easily mapped according to emerging and developed markets or any other regional segregation. For instance, family-controlled companies are equally common in Sweden and Hong Kong; state-controlled companies are more common in Norway than in Russia[7]. Each ownership model has strengths and weaknesses, with the approach to governance varying accordingly. While there is no optimal ownership model, we believe that some principles for board effectiveness hold true regardless of the corporate control structure.

### Figure 2

**Widely-dispersed ownership**

Companies in which there is no controlling shareholder. These structures are common in the Anglophone world, with over 80% of public companies in Australia, the UK and Ireland taking this form[7].

**Concentrated ownership**

**1**
**Founder-controlled company**
Companies in which the founder exercises disproportional voting and decision-making power, often through shares with unequal voting rights. A founder may retain control by holding executive or non-executive positions, often acting as the chair and/or CEO.

**2**
**Family-controlled company**
Companies in which the family, often the founder's family, have retained control. The presence of family members in executive positions and on the board usually indicates strong influence. The family is also likely to maintain control through direct shareholdings or unequal voting share classes. Over 90% of companies in the Philippines and over 75% of companies in Mexico take this form[7].

**3**
**Corporate/government-controlled company**
Companies in which the primary shareholder is the government or a parent company. By controlling over 50% of the voting rights, governments or parent companies can determine the direction of the company.

**4**
**Significant stake company**
Companies in which a group of entities (individuals or companies) acting together, usually bound by an agreement, hold over 50% of the voting rights. The group can, therefore, propose and support changes with ease.

Source: OECD (2018), Board Evaluation: Overview of International Practices



# Principle 1: Genuine independence, diversity and inclusion

- A group of independent directors with the necessary psychological capabilities to make sound judgements is critical to a board
- Diversity between directors across multiple dimensions is a reliable method of improving board dynamics and decision-making, when accompanied by an inclusive board culture
- Skill sets and experiences must be aligned to the company's strategic priorities, including a responsibility for each director to educate themselves on the sector and company

We expect a board to take independence seriously. Regardless of the ownership structure and the market context, the independent directors on a board have a critical role in offering an external perspective that reduces the risk of groupthink, stunted innovation and tunnel vision in the boardroom. They are most effective when served by a senior independent director.

The level of independence, as defined by a set of measurable characteristics such as tenure and former relationships, may meet local corporate governance codes and tick the necessary "good governance" boxes. However, the more important test is whether the directors who are deemed independent can fulfil the role that is expected of them, especially the need to critically assess and influence.

To act as an independent director, one must be able to draw on a set of personal psychological capabilities and past experiences that give rise to the strength of character and emotional intelligence required to challenge executive management and hold them to account; not all directors who are considered independent on paper will live up to this definition. A board culture that actively promotes independent thinking is critical, but independent directors must aim to fulfil their duties and exercise sound judgement even in the absence of such a culture. Independence is particularly important in companies with concentrated ownership, be this control by a family, founder, state, or corporation.

Seeking genuine diversity and inclusion should be another priority for a board. Diversity in its broadest sense – including skills, experience, gender, nationality, age, ethnicity, sexual orientation, and networks – is consistently shown to result in improved culture, quality of debate and decision-making[8]. Diversity in personality types and psychological attributes also falls into this category, although it remains an often-overlooked aspect of board diversity, both by investors and board directors themselves. Most methods of assessing personality and innate behavioural characteristics derive from Jungian psychology, with Myers Briggs being the most well-known. The importance of psychology and behaviour in board performance is well summarised in Annex 4 of David Walker's review of UK corporate governance following the financial crisis[9].

Diversity across all dimensions becomes a slightly simplified proxy for the diversity of thought on the board, provided that diversity is accompanied by an inclusive and egalitarian board culture[10]. Studies have shown that higher gender diversity on the board, for instance, has a causal relationship with reduced financial risk, higher investment in research and development, and more efficient innovation processes[11].

Our engagement with directors across different markets repeatedly confirms this perspective; it may take longer to reach a consensus when directors have different approaches and perspectives, but the overall outcome is likely to be better. Continuing to improve board gender diversity remains important, as does adopting a more holistic view of diversity and its role in a company's long-term success. Diverse voices that challenge the norm are invaluable in all companies and especially in those where a controlling shareholder is dominant on the board.

> Directors should have the confidence to create discomfort if necessary. They should bring their perspectives to the boardroom when it is in the best interests of the company, even when this means going against the status quo.
>
> **– Independent director, Brazil**

A strong mix of relevant skills and experiences on the board is critical, especially given a board's expanding remit. Directors with a wide range of tenures, including some with deep knowledge of the company over time and some who offer a fresh perspective, can help to achieve the balance. Directors must exhibit a thorough understanding of sector and industry dynamics, including the commitment and ability to educate themselves on key trends, innovations and disruptions in the sector. A knowledge of products and product cycles is also considered an asset for a board[6].

We expect directors to be proactive and agile in their approach; they must take personal responsibility for continuous learning, avoiding over-reliance on historic experience and ensuring that their understanding is current. Our engagement with directors has highlighted the importance of each board director being able to contribute to most topics in a meaningful manner, rather than relying on a single "expert" to make decisions in their area of expertise. In the most extreme cases, individuals' lack of knowledge and understanding could negatively impact overall board effectiveness. Potential skills gaps on the board can be identified and addressed through a board evaluation, as will be discussed in *Principle 5*.

Attaining high diversity, independence, and a good skill set on the board remains an urgent task across markets, including emerging markets, such as India and Russia, and developed markets, such as the United States and Japan. This principle applies regardless of how the board is structured, what the control arrangements are, and how the nomination process works. For instance, succession planning in some companies is driven by the controlling shareholder rather than an independent nomination committee. A sound board composition can be achieved in the presence of a controlling shareholder and in a dispersed ownership model, provided that there is genuine commitment from directors.

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## Principle 2: The role of the chair

- An independent chair is best placed to create the overall conditions for board effectiveness
- The chair plays a unique role in creating an open, respectful and trusting board environment
- To avoid groupthink, the chair must actively encourage independent and critical thinking

We strongly believe that the chair should be independent so that they can most effectively conduct their unique role on the board. The UK Financial Reporting Council's (FRC) Guidance on Board Effectiveness states that, *"The chair is pivotal in creating the conditions for overall board and individual director effectiveness…"*

In other words, the chair is responsible for establishing the board's hardware and for ensuring that the software is fit for purpose. This responsibility is different to that of an executive role; the chair acts as a coordinator and facilitator, leading the board of directors but not the company[12]. The distinction is important in explaining why having a joint chair-CEO is not desirable: the skill requirements for the two roles differ.

Many chairs have previously served as executives and must undergo a conscious and unreserved switch in mindset when they assume the chair role. Rather than executing decisions and driving outcomes, the chair's focus should be on listening, creating a positive environment, and implementing processes that empower others. An independent chair is best placed to create the desired overall conditions, with the goal being to enable the board to make good decisions collectively on behalf of the company and its shareholders.

"The chair must encourage a free and open exchange of information, views and suggestions between board members. Ensuring that the board discussion is effective, fruitful and constructive is much more important than the number or length of board meetings."

**– Independent director, China**

The chair should lay out and enforce clear expectations for the culture, tone, and style of the board. This requirement applies when directors are appointed to a board, and throughout their involvement. In our view, the main cultural expectation should be that directors foster genuine, trusting, and respectful relationships with one another. This social dynamic, which cannot be captured through a data point, is a pre-condition for fruitful debate and a robust board. In what has been called a "virtuous cycle of respect, trust and candour", individuals who exercise mutual respect develop trust and become more likely to share difficult information, enabling the board to engage in constructive debate[13].

In practical terms, the chair should offer equal opportunities for all voices to be heard and all ideas to be explored, rather than enabling a few directors to dominate discussions. The quality of chairing is especially important for highly diverse boards, which require careful coordination to effectively draw out individual and collective strengths. It goes without saying that the expectation for mutual respect amongst directors applies across all structures of corporate control and in all markets.

Another key cultural element that the chair should actively convey is the necessity for nonconformism, albeit skilfully balanced with the need for consensus on some matters. The chair must create an environment of honesty, as well as playing devil's advocate if required, to encourage directors to question assumptions and challenge long-standing ideas. Recent research based on input from 750 directors suggests that chairs of "gold medal" boards actively seek out different viewpoints, encourage independent thinking, and facilitate high-quality debates[14].

Even if independence is true on paper, the chair plays a significant role in drawing out the behaviours of independent thinkers. Our engagement with board members has highlighted that healthy tension is critical for a well-functioning board, with excessive conformity a warning sign. Continuous agreement raises concerns about groupthink, a behavioural phenomenon that occurs when the desire for conformity and minimal conflict causes social dynamics to impede frank debate and critical reflection[15]. Individual biases, which are inherent to all human beings, may be exacerbated in groups with negative social dynamics. The chair should be highly attuned to the risk of groupthink, countering the risk by actively encouraging deliberation within the group.

Different structures of corporate control may give rise to challenges that prevent the chair from exercising the desired characteristics, especially when the chair is not independent. The chair may not feel empowered to guide the board in the way they would like, which often happens when a controlling shareholder is on the board but not in the capacity of chair. If the chair is the controlling shareholder, they are more likely to assume a dominant position on the board and restrict healthy debate.

Similar challenges may arise in companies where the chair has been nominated by the controlling shareholder, be it a state, family, or corporation. In a family-controlled company where the chair is also a family member, there may be a heightened risk of factions forming and dominating decision-making.

Critically, a non-independent chair must actively encourage the presence of independent directors on the board, including a senior independent director. A strong group of independent directors acting as a valuable counterweight is in the chair's enlightened self-interest. If the non-independent chair fails to create the desired conditions on the board, the group of independent directors becomes even more important. Our engagement with company directors, including those from family-controlled companies, has

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demonstrated that some non-independent chairs can successfully assume the role of coordinator and facilitator, often without letting their opinion be known. If the chair is committed to establishing well-functioning board software, their affiliation is not necessarily a hindrance. In fact, empirical research shows that families are more likely to act in the long-term interests of their company and override short-term market pressures[16]. Although it remains difficult to fully comprehend complex human dynamics, focused engagement with the chair and other board directors can inform an assessment of the chair's approach in individual company circumstances.

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# Principle 3: How the board allocates its time

- Boards must maximise the time spent discussing strategy and other forward-looking activities, including purpose, culture and succession planning
- The information provided before board meetings and the meeting agenda must be precise and reflective of the board's priorities
- Board directors must be highly engaged in the company, remaining involved between board meetings through committee work, discussions with key skakeholders and regular training

A board's limited time must be spent efficiently and effectively. A continuous challenge is overcoming the short-term pressures from the market by adopting a long-term perspective[17]. This approach should be evident in how a board's time is allocated during and between board meetings, as well as in how the board guides management.

The pressures on a board's time will vary depending on a company's circumstances, including local regulation, although we expect some focus areas to supersede contextual factors. We strongly endorse board oversight of material issues, as they are likely to be long-term value drivers for the company. However, we question the feasibility and sustainability of making boards responsible for everything, especially as regulatory responsibility is also increasing.

A more fruitful approach is to expect boards to prioritise issues where they can add the most value and where their strategic direction would encourage positive change throughout the company. The responsibility for prioritisation also sits with the chair, including ensuring that the board agenda is not completely driven by the CEO. The company secretary, in markets where the role is common, plays a complementary role in shaping the board's agenda.

**Important but non-urgent**

Dwight Eisenhower, who served as a general in the army before becoming the 34th president of the United States, stated that: *"I have two kinds of problems, the urgent and the important. The urgent are not important, and the important are never urgent."* This reflection is relevant to many boards, where the need to deal with urgent matters and crises sometimes comes at the expense of addressing what is important for the company's long-term success. This tension must be acknowledged and carefully managed. The chair's guidance and habits generated over time help to develop a board culture that fosters discussions about matters that are important but not necessarily urgent. The most pertinent topics in this category include purpose, strategy, risk, succession planning, values, culture and innovation.

The board plays an important role in articulating a company's purpose. There is an increasing expectation that a company's purpose should serve stakeholders, society and the environment, as well as shareholders. The purpose should be deeply embedded throughout the company, with the company's strategy enabling the realisation of its purpose. The board's activities should reflect a commitment to the purpose, most explicitly through careful scrutinisation of the strategy.

The board is in a unique position to consider the risks and opportunities presented by economic, demographic and technological shifts; such strategic oversight is invaluable for securing company value and competitiveness in the long-term[18]. Yet, studies consistently indicate that boards underperform on strategic matters, often by not fully comprehending how the company currently creates value and by having an insufficient grasp of industry dynamics[19].

The fifth McKinsey Global Survey[20], to which more than 1,100 directors provided input, highlighted that few boards routinely discuss and deeply understand potential business disruptions, such as digitalisation or regulatory changes, although the number of boards that do so has increased compared with several years ago. Geopolitics also falls into this category, as political developments such as trade disputes or changes in domestic and international policies may affect a company's prospects, even if they are far beyond the board and management's control.

"The best directors are the ones who stay engaged not just in the boardroom but between meetings. They are good listeners and good students who initate conversations with others to expand and check their own thinking.

**– Independent director, UK and US**

We expect boards to maximise the time spent on strategy and other forward-looking activities, whilst inevitably having to address other issues. Priority topics for effective boards include strategic planning or review, oversight of major transactions, and succession planning for management[14]. These boards reduce the time spent on reviewing financial statements and compliance-related activities. Audit remains an important function of the board, although it should not distract the board from taking a forward-looking view.

Strategic discussions should be embedded in a board's modus operandi, rather than featuring in an annual presentation from the CEO or a single strategy day per year. The risk of the latter approach is that the board may feel pressured to reach a conclusion, forcing decisions and hindering organic idea generation. The chair must foster a culture where a high-quality strategic discussion is itself a deliverable, even if there are no immediate tangible outcomes. While detailed information about time allocation should not be publicly disclosed, an understanding of a board's priorities – including the extent to which it focuses on strategy – can be ascertained through direct engagement.

The type, quality, and format of information supplied to the board in preparation for board meetings is instrumental in shaping the discussion. The push for boards to have access to non-financial metrics has led to board members frequently commenting that board packs have become too long and difficult to digest. Boards will differ in their information needs and preferences, and a board's needs will change over time; information packs must be adapted accordingly.

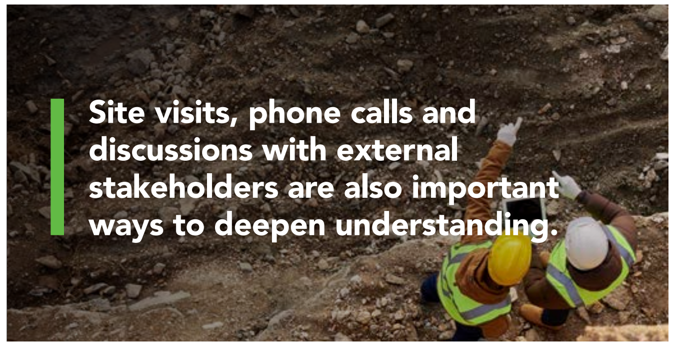
Helpful methods for presenting information include infographics and short white papers that outline the CEO's perspective on a key topic[21]. Some boards have found online memos in narrative form with direct links to supporting analysis on the company's internal shared systems to serve the board well[22]. Many board directors also find it helpful when board discussions are informed by regular presentations from external and internal experts. Rapid technological developments, including artificial intelligence and big data, are likely to affect how companies receive and interpret data. It is imperative that the board provides feedback on the presentation and content of pre-meeting information packs, so that the approach can be amended for the next board meeting.

The board meeting agenda should reflect the board's priorities through its content and ordering. For instance, if people are recognised as a company's core asset, it should not be unusual for a board to begin board meetings by discussing the company's human capital strategy. We also expect strong boards to feature company culture on their agenda. Research shows that boards that actively discuss corporate culture at more than 50% of board meetings are significantly more likely to operate in companies where the culture reflects the desire of the board[14]. Discussions about culture should be honest and critical, getting to the core of potential issues and shaping a cultural vision.

As boards across the world appear to underperform on succession planning[23], we believe that this topic should routinely feature on a board's agenda. Proactive succession planning for the board and management is critical even when there are no tenure limits; such activity demonstrates a commitment to the company's long-term success far beyond individual directors' time serving on the board.

The succession planning process should actively seek out diverse candidates with a range of experiences, including individuals who have seen companies through significant transformation or a process of recovering trust. Engagement between the board and investors can provide reassurance that the board meeting agenda accurately reflects the board's prioritisation of strategic and forward-looking matters.

Board meetings, especially in some markets, are formal and somewhat formulaic. This is not necessarily conducive to idea generation and thoughtful reflection. We encourage boards to form and make use of committees for deep discussions of material issues; our engagement with a range of directors highlights that substantive insights and actions can result from committee work. The growth in the number of topics that the board is expected to oversee makes committee work increasingly valuable. External consultants and topical experts can be called upon to support committee work, either regularly or as occasional sessions.




Board directors should remain deeply engaged in the company between board and committee meetings, indicating the high level of time and commitment that is required to fulfil the role. Directors can use a variety of methods to get under the skin of a company, including seeking their own data points and forming a view based on the reality outside the board room. This approach involves meeting with a range of executives, rather than just the CEO and the CFO. Site visits, phone calls and discussions with external stakeholders are also important ways to deepen understanding.  We expect board members to visit important sites of operation and engage with suppliers, customers and community members, if relevant. Regular training and development opportunities, such as conferences, expert briefings and tours of external organisations, are also key to keeping the board informed.

While public disclosures can indicate the number of board meetings per year, engagement between investors and board directors can inform a much more nuanced understanding of how board directors operate during and between board meetings. Across all structures of corporate control, we hope to see board directors who are actively engaged and a board that allocates time to matters that are important, though not necessarily urgent, for a company's future.



## Principle 4: The board's relationship with the CEO

- The chair and CEO roles should be held separately, with the relationship characterised by transparency, trust and constructive collaboration
- Independent directors should regularly meet in the absence of executives when the board is composed of both executives and non-executives
- The board should seek out the "employee voice" through formal and informal communication channels

Boards are responsible for appointing CEOs, holding them to account, setting their pay, dismissing them, and overseeing their decisions. The quality of the relationship between the board and the CEO is one of the most important factors in determining whether CEOs – and therefore companies – are successful[24]. An ideal relationship would entail high transparency and trust, open feedback and communication about concerns, and constructive collaboration focused on the company's long-term prospects.

The CEO should understand, use, and value the board as a strategic asset, given that the directors are likely to have rich experiences and perspectives[21]. The board should provide advice, ask challenging questions and intervene when necessary. Both parties must establish clear expectations and distinct responsibilities[25], whilst building strong relationships centred on humility, respect, and openness. These aspects of a board's "software" may be difficult to implement in practice, especially within some board structures and forms of corporate control.

Furthermore, despite the importance of the relationship between the board and the CEO, no corporate governance metrics can assess the dynamic between the individuals in question. Engagement with board directors and the management team, on the other hand, can offer a valuable insight into how constructive or concerning the relationships are.

> A good professional relationship between the chair and the CEO is most important. If there is a disconnect or a lack of respect, it becomes a problem for the board, the efficiency of governance and for the company overall.
>
> **– Chair, Germany**

It is common in most markets for one or more executives to be on the board. When boards are comprised of both executive and non-executive directors, they are all bound by the same collective responsibility to the company and its shareholders. There are exceptions to this structure, such as in Germany, where there is a dual board structure consisting of a supervisory board and a management board. However, in cases where executive directors are present on boards, they are required to hold two separate roles simultaneously: as an executive who manages the day-to-day operations of the company and as a board director who oversees the executive team in managing the company. There are several problems with this.

**The CEO should understand, use, and value the board as a strategic asset, given that the directors are likely to have rich experiences and perspectives.**

Firstly, this arrangement gives rise to personal conflicts of interest, in which the executive directors are unlikely to objectively assess their own performance. The most extreme instance of this arrangement is a joint chair-CEO role, as the chair cannot guide a board to hold the CEO – him or herself – to account.

Secondly, executive directors have more in-depth and current knowledge about the company than non-executive directors, creating an asymmetry of information. Independent board directors may suffer from "informational capture"[26], whereby the time constraints of their part-time role and inadequate capacity to process information make them too reliant on the perspectives provided by executive directors. This arrangement may jeopardise independent thought and reduce the quality of debate on the board.

The risk of "informational capture"can be somewhat mitigated by all directors being thoroughly prepared for board meetings so that they are equally able to contribute. A comprehensive and immersive induction plan for new directors joining a board is necessary to enable an effective contribution from the outset[27]. Moreover, it is imperative that independent directors regularly meet in the absence of executives, including formally before or after each board meeting and informally as concerns arise. Such meetings enable open discussions about management's performance, remuneration, and other sensitive topics.

The latest McKinsey Global Survey indicates that it is uncommon for board meeting agendas to routinely feature discussions in the absence of executive directors[20]. However, from our engagement with independent directors, we understand such meetings to be instrumental in raising and addressing concerns.

Across markets, a common worry is that a dominant CEO may hinder board members from effectively conducting their duties. Such a situation may arise where the CEO is the founder and controlling shareholder, or due to personality and psychological attributes that are independent of the ownership structure. The risk of hubris may be exacerbated if the CEO and company perform well.

We engage with company chairs and independent directors about interactions and relationships to identify instances where the board is unable to challenge a dominant CEO; we seek to avoid instances where the relationship becomes a "glitch" in the board's software that weakens overall board functionality. In such cases, we explain our concern about CEOs that see boards solely as "advisers", rather than entities to whom they are accountable. Once the concerns have been identified, the chair or the independent directors can reiterate expectations and reinforce boundaries.

Board directors may be equally responsible for weak relationships between the board and the CEO. Some CEOs highlight that boards are risk averse when it comes to significant strategic decisions, either due to fear of bad press or concerns about personal reputation[28]. Other CEOs indicate that boards are not always well-equipped to conduct "intelligent stress testing" due to a lack of preparation and an inadequate understanding of industry or market dynamics.

Structures of corporate control may give rise to further challenges: the CEO may feel less able to openly communicate concerns if several representatives from the controlling shareholder are on the board. A family member CEO in a company with multiple family members on the board may distort the desired relationship between the board and the CEO. Constructive engagement can serve as a tool for both companies and investors, exposing challenges and identifying areas for improvement.

Across all structures of corporate control, we expect board directors to reach out beyond the CEO to build relationships with the workforce. Drawing out the "employee voice" can be achieved through a combination of formal and informal channels. Regular site visits, observing team meetings, and discussions with randomly-selected employees can be constructive. Alternatively, the board can propose structural changes, such as employee representation on the board, a workforce advisory panel, or a designated non-executive director for employee engagement.

The CEO should encourage board exposure to the management team and to a range of employees across the company. These lines of communication increase the board's capacity for critical reflection on company culture, human capital management and strategy. Though inevitably an imperfect reflection of the employee voice, we expect the board to use these methods to gather strategic insights and recalibrate the board's focus.

**The risk of "informational capture"can be somewhat mitigated by all directors being thoroughly prepared for board meetings so that they are equally able to contribute.**



## Principle 5: A commitment to continuous improvement

- Board evaluations, when conducted with genuine commitment from directors rather than a compliance exercise, are one method of assessing and improving board performance
- Internal and external evaluations can be used to recalibrate focus, identify skills gaps, highlight the need for succession, and identify cultural or performance concerns
- An action plan and timeline for implementing the changes is as important as disclosure of the findings themselves

We encourage boards across markets and different structures of corporate control to conduct regular board evaluations to help improve board effectiveness. Board functionality requires regular testing in the same way that a device's hardware and software undergo routine testing and improvement. The process, when conducted well, offers a unique opportunity for the board to pause, reflect, and optimise performance. Board evaluations are recommended in many markets; the UK's Corporate Governance Code endorses an annual board evaluation, accompanied by an externally-facilitated board evaluation every three years for FTSE 350 companies[29].

However, formulaic board evaluations that are conducted as a basic compliance exercise generally fail to inspire positive change on the board. Instead, board evaluations should reflect a genuine commitment to continuous improvement from all board directors.

An effective board evaluation, which is better thought of as a board performance review, is likely to reduce, rather than eliminate, the risk of corporate governance failure. Research from the UK suggests that the main benefits of board evaluations are recalibrating focus, agreeing priorities, raising issues and prompting open discussion[30], although the needs and opportunities will vary between boards. The process can be used to review the board's strategic input, identify skills gaps on the board, highlight the need for succession, and raise concerns related to performance and culture.

The board evaluation should critically explore the board's software, especially with regard to the interpersonal and group dynamics between directors[31]. Board evaluations can be helpful in expanding the chair's understanding of the board, which increases their confidence and ability to provide guidance. Finally, as we stress in our engagement with boards, conducting board evaluations signals to investors that the board is open to constructive criticism and willing to improve.

> "Board evaluations are a useful tool, especially when they consider behaviours and attitudes. They can result in the addition of board members with complementary skills, the formation of new committees and improvements to process efficiency."
>
> **– Independent director, Russia**

Internal and external board evaluations are likely to differ in formality, structure and method, yet both forms can offer valuable insights into a board's performance. If a board chooses to use a combination of the two methods, we expect synergy and continuity between them. External reviews introduce a valuable outsider's perspective to sense check the board's dynamics and effectiveness, with the goal of highlighting areas for further improvement. They are generally more rigorous and structured than internal board evaluations, although also more time and resource intensive[29]. Methods should include a combination of one-to-one interviews, reviews of materials, and observations of board and committee meetings.

The availability and reliability of external reviewers varies significantly across markets. In the UK, where the process is relatively well established, there are attempts to elevate the quality of board evaluations. A government consultation led by the Institute of Corporate Secretaries and Administrators (ICSA) is exploring a code of practice for board evaluation providers, voluntary principles to be applied by companies who undertake board evaluations, and guidance on disclosure for listed companies[32].

An internal board evaluation, which is usually conducted through one-to-one meetings with the chair, may feature a greater depth of company knowledge. Although likely to be less objective, the internal board evaluation may offer a more personal reflection on a board's performance. We expect directors to engage openly and enthusiastically with the process, regardless of the form and method chosen.

**An effective board evaluation, which is better thought of as a board performance review, is likely to reduce, rather than eliminate, the risk of corporate governance failure.**

The disclosure of board evaluations must strike a delicate balance between providing reassurance to investors and maintaining confidentiality. An action plan that seeks to improve board performance and a timeline for implementing the proposed changes are as important as the findings themselves. As such, we expect disclosures to explain the process for evaluating board performance: how the external evaluator was selected for their independence and quality, how the scope was agreed, which methodologies were used, and how the feedback was provided. The disclosure should illustrate that the necessary steps have been taken to improve the board in the best interests of the company and its shareholders.

In theory, all boards should be able to engage in a robust board evaluation. In practice, the process may be complicated by the lack of service availability in some markets and the structure of corporate control. The presence of a controlling shareholder on the board, such as a government or family representative, may reduce the board's willingness to engage in a genuine evaluation exercise. Family members on the board of a family-controlled company may be less open to undergoing a performance evaluation. In these instances, a superficial board evaluation may be conducted to comply with local regulation, but it is unlikely to yield helpful insights for the board.

Through engagement with directors, we seek to assess how committed the board is to a substantive board evaluation process. We stress that a board evaluation is a useful tool for improving board performance, regardless of the board structure or control arrangements. In the same way that an electronic device undergoes regular testing and improvement, the board evaluation process should test how well the board's hardware and software are operating together in order to optimise overall board functionality.

**We encourage boards across markets and different structures of corporate control to conduct regular board evaluations as one method of improving board effectiveness.**

## Conclusion

Public disclosures from companies offer a limited perspective on the quality of corporate governance. As this paper has argued, an assessment of a board's "hardware" components must be supplemented by an investigation of the human, relational, and behavioural aspects. The "software" characteristics of a board are difficult, if not impossible, to capture through a data point. Instead, valuable insights can be gained through dedicated and continuous engagement between investors and board directors.

No formula can guarantee board effectiveness. Establishing a good board is never about ticking boxes; it is about understanding and doing what is best for the long-term prospects of a company and its shareholders. However, we believe some principles hold true regardless of the board structure, the corporate control arrangements, and the operating market. In this paper, we have focused on five guiding principles. In the future, we will elaborate on other critical aspects of a board's software, not least the form and extent of engagement between board directors and investors.

There is increasing pressure on boards to get their approach right, especially considering the high degree of scrutiny from regulators and the public, and the evolving corporate context. Board directors, therefore, have a responsibility to provide strategic guidance on the culture, behaviours, and incentives that will drive long-term value generation. A board can interpret and apply the five guiding principles outlined in this paper according to a company's particular requirements, with the ultimate goal of enhancing board effectiveness.

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