CAMBRIDGE

Cambridge University Press
978-1-108-97139-3 — Board Dynamics
Philip Stiles
Excerpt
More Information

1 Introduction

The role of the board is changing. A movement is developing which urges the board to focus on corporate purpose, and its contribution to social purpose. A number of major recent initiatives, notably the British Academy's work on 'The Future of the Corporation' (Mayer, 2018), and the US Business Roundtable's 'Statement on the Purpose of a Corporation' (Business Roundtable, 2019), have identified serious shortcomings in the way firms are run and have identified the need to reject shareholder primacy – the view that the only purpose of a business is to maximise shareholder returns – to argue for the idea of stakeholder governance and the promotion of purpose and trust.

The dangers of a shareholder-centric view, and its attendant problems with short-termism, have been made clear by these and other important contributions (Kay, 2012; Lawrence, 2017; Lipton, 2019; Sikka et al., 2018; World Economic Forum, 2016): increasing macroeconomic and financial instability, reductions in long-term competitiveness, fewer investments in innovative capability and decreased worker productivity.

These reports are the latest manifestations of an enduring debate about how to make governance more effective, and the role of the board within this. Some commentators argue that we have been here before. Concerns about short-termism have been a feature of the corporate governance landscape for a long time (see, for example, Marsh, 1993). Economic failure is nothing new; crises and scandals emerge regularly, prompting periodic calls for action (Clarke, 2010). Committees are set up, codes and various reforms are written, exemplars are lauded, transgressive companies are vilified. The board of directors tends to be singled out and viewed as suboptimal and in need of serious attention.

But this time feels different. The calls to action that opened this section suggest a sense of urgency and a common cause centred on the need to redress the problems caused by a shareholder-centric perspective, and the dangers of short-termism. For example, investors held shares on average for six years in the UK in the 1950s. That figure is down to six months now (Lawrence, 2017). This short-termism is mirrored in the USA. An important precursor to the Business Roundtable Statement of Purpose – Vitol's Principles 2.0' – argued that one of the principal reasons for the decline in numbers of public companies was the short-term perspective taken by investors that discouraged firms with a longer-term view (Commonsense Principles 2.0: para. 2).

Though the new governance initiatives differ as to whether regulation should be used to enforce a greater long-term value perspective (the British Academy work favouring a change in corporate law to place purpose at the heart of the objectives of the corporation, while the Business Roundtable Statement for

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-97139-3 — Board Dynamics
Philip Stiles
Excerpt
More Information

Purpose advocates a voluntary adherence to its principles based on an enlightened shareholder view), they share a common theme about the board of directors needing to raise its game. Directors are urged to provide effective contributions to ensure that the organisation follows purposeful objectives that have a long-term perspective (Lipton, 2019). The board therefore has a key role in ensuring that corporate purpose is enshrined within the organisation and its operations.

To deliver a corporate purpose that benefits society is wider than purely having a focus on corporate social responsibility. Rather it concerns how a board and the organisation can make a positive impact on environmental and social concerns within wider communities (Silverstein, McCormack, and Lamm, 2018).

A number of proposals have been put forward to support this view. First, boards have been asked to create a corporate purpose statement which highlights what the organisation does and why it does it (The Purposeful Company, 2018). A major board role would be to align the organisation's strategy, values and culture behind this statement of purpose (Mayer, 2018). This would be demonstrated by the board regularly communicating to stakeholders how the organisation is progressing in this alignment (Lipton, 2018).

Traditionally, social purpose and impact have been seen in terms of corporate philanthropy (for example, sponsorships) or as a targeted set of initiatives on particular issues (such as sustainability or diversity themes). More recent approaches have seen organisations approaching social purpose as an enterprise-wide commitment (Silverstein et al., 2018).

Second, a large part of delivering a corporate purpose that benefits society will be ensuring that the board attends to environmental, social and governance (ESG) issues. ESG is wide-ranging, encompassing employee relations and workplace practices, consumer and product safety and data security, environmental liabilities, supply chain and energy alternatives, board diversity, executive pay and business ethics. The Institutional Shareholder Services (ISS) review on ESG highlighted issues such as climate change, responsible consumption, data use, and discrimination as major concerns for boards (ISS, 2019: para. 4).

Managing ESG risk is a major element in the board's risk oversight role (Lipton, 2015). A number of organisations have created a separate board subcommittee to focus on the developing set of issues involved (Lipton, Niles, and Miller, 2018).

The board's potential for delivering social purpose is considerable. A board of directors is generally considered to perform two major roles (Hillman and Dalziel, 2003). The first is to "monitor the performance and behaviours of the

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-97139-3 — Board Dynamics
Philip Stiles
Excerpt
More Information

management and to ensure accountability to the owners and stakeholders" (Hambrick, Misangyi, and Park, 2015: 323), including the review and approval of strategy and the evaluation of the internal controls and risk (Daily, Dalton, and Cannella, 2003; Judge and Zeithaml, 1992). This role is strongly informed by agency theory, which asserts that the board is the key mechanism for aligning the interests of the agent (the management of the company) with the principal (the owners and/or stakeholders) (Fama and Jensen, 1983; Hermalin and Weisbach, 2003). The second is a resource and service role, in which directors provide advice to executives, and in addition facilitate contacts, knowledge and resources between the organisation and its stakeholders (Hillman and Dalziel, 2003). This role is informed by the resource-dependence perspective, which highlights the important benefits directors bring to the organisation, chiefly, new information given through sharing advice from external sources, preferential access to resources and knowledge from outside the organisation, and legitimacy (Hillman, Withers, and Collins, 2009: Pfeffer and Salancik, 1978).

Both agency theory and resource dependence theory view the board as providing a mechanism of oversight and service to management, and as a result having a positive effect on the governance and performance of the firm. Other theories of the board, such as stewardship theory (Donaldson, 1990; Davis, Schoorman, and Donaldson, 1997) and team production theory (Blair, 1995; Blair and Stout, 1999, 2011) challenge agency theory assumptions about directors seeking to maximise their own interests, but concur on the board's significance as the focus of monitoring and advice-giving to enhance decision-making and accountability for the organisation.

The enactment of these roles depends on the contribution of independent non-executive directors, defined as those who are not current or former company employees or otherwise linked to the company or its managers (FRC, 2018). This independence from the organisation allows them to have an objective view of the organisation's strategy and operations, thus strengthening the monitoring capability, and also to be in a position to bring new information and resources and contacts external to the organisation (Westphal and Bednar, 2005).

Regarding social purpose, in the monitoring role, boards can enquire of management whether the decisions and investments needed to fulfil their social purpose, and the risks associated with them, are being enacted. In the advice-giving role, boards can contribute to the strategic debate on social purpose, providing new information on social purpose activities and trends from outside the organisation and ensuring a broad discussion on the organisation's long-term social impact.

However, while all this in principle sounds workable, boards find it difficult to fulfil their roles. A recent influential review argued that boards may be in

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-97139-3 — Board Dynamics
Philip Stiles
Excerpt
More Information

a real sense 'set up to fail' (Boivie, Bednar, Aguilera, and Andrus, 2016). Some question whether directors have the ability to fulfil their roles adequately (Hambrick et al., 2015). For example, the extent of directors' other commitments may be overwhelming. At the level of the board, a powerful CEO can inhibit directors from actively making useful contributions, and the presence of certain board norms, such as deference and reciprocity, may severely limit directors' impact and value on the board. At the organisation level, most firms are characterised by complexity which makes understanding of the business (and information processing) very difficult indeed (Boivie et al., 2016; Hoppman, Naegele, and Girod, 2019).

The continuing presence of scandals in the corporate landscape, such as Carillion, HSBC, London Capital and Finance, Theranos, among many recent others, seems to support the view that the board faces an impossible task. A major theme of this Element is therefore to examine whether the board can manage these tensions and contribute effectively to delivering on the organisation's social purpose. I will focus on two key strands of debate. The first concerns structure. Since the thesis of the separation of ownership and control put forward by Berle and Means (1932), investors, policy makers, regulators, and governance scholars have emphasised the structural dimensions of governance, notably splitting the chair and CEO roles, ensuring a critical mass of independent directors, and introducing a raft of board committees to increase the scrutiny on management. Given the increasing demands for social purpose, it may be that the current structures do not allow the board enough latitude to pursue a broader purpose. We shall look (section 5) at a number of proposed reforms to the board in particular that may address this situation, including changing directors' duties to explicitly treat stakeholders on the same footing as shareholders (Lawrence, 2017; Sikka et al., 2018) and widening democracy on the board, beginning with the inclusion of employee directors. Experience of employee directors in European countries suggests that they result in better industrial relations and they prioritise longer-term performance horizons (Vitols, 2010).

The second key strand for debate focuses on the relational aspects of boards. A major reason for boards not fulfilling their roles effectively concerns the nature of interactions within the board. Work on behavioural governance suggests that 'widespread social norms for directors' behaviour often prevent corporate boards from fully exercising their control function on behalf of stakeholders' interests' (Westphal and Stern, 2006: 189) and cause non-executives to defer to executives and particularly the CEO.

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-97139-3 — Board Dynamics
Philip Stiles
Excerpt
More Information

On this view, boards are formed of individuals of varying backgrounds, personalities, motivations and ambitions, and the degree to which they come together behind a common board and organisational purpose will depend on how the relationships between them are managed. The behavioural view highlights how boards are socially situated and constituted, in contrast to agency theory, which says little about the actual dynamics that occur within a board (Westphal and Zajac, 2013). This point is often downplayed in talk of board reform, possibly because it reflects an unease that relationships cannot really be legislated for, and so remains an area where there can only be bland prescription and entreaties to behave well. This can be seen when researchers seek to link board structural characteristics to hard outcome measure of the firm, such as financial performance, The results of such research have yielded little (c.f. Desender, Aguilera, Crespi, and Garcıa-Cestona, 2013), suggesting that the dynamics of the board and the ways directors make decisions have to be taken into account when considering the overall effect of boards on their organisations.

For boards to be effective and to deliver the imperatives of purpose-driven organisations, there must be a context of trust and collaboration between directors in order for information to be shared and processed. Directors must engage in behaviours that build confidence in each other's firm-specific and general business expertise (Kor and Sundaramurthy, 2009). There must also be a board culture within which discussions take place that can be characterised as challenging but supportive, with directors able to express dissenting views without fearing a loss of status. Through such dynamics, accountability can be developed, with accountability conceived here as stemming from a board which ''questions intelligently, debates constructively, challenges rigorously and decides dispassionately'' (Higgs Review, 2002: Annex C, para. 7). The importance of collaboration within the board rests alongside the need for directors to ensure control (Sundaramurthy and Lewis, 2003). This tension, which reflects the two roles of the board as monitor and advice-giver, thus can be mutually reinforcing, with informed directors whose expertise and engagement engender trust within the board, able to contribute ideas freely into discussions on strategy and operations, and this same trust provides confidence and acceptance that monitoring is carried out in a supportive and collegial manner (Lipton, 2019; Sumdaramurthy and Lewis, 2003; Roberts et al., 2005)

There must also be trust between directors and stakeholders, particularly concerning the need to deliver on purpose (Mayer, 2018). The board's role in setting the appropriate culture or 'tone from the top' is important here. The board's role in organisational culture and in risk culture represents a major dimension of its work.

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-97139-3 — Board Dynamics
Philip Stiles
Excerpt
More Information

In this Element I will discuss ways in which the board can enhance the relational elements of its work and examine how boards set the 'tone from the top' to develop culture and ultimately deliver corporate purpose with social impact.

The structure of the Element will reflect the perspective of the board as a particular kind of workgroup. Workgroups can be defined as 'collectives who exist to perform organisationally relevant tasks, share one or more common goal, interact socially, exhibit task interdependencies, maintain and manage boundaries, and are embedded in an organisational context that sets boundaries, constrains the team, and influences exchanges with other units in the broader entity' (Kozlowski and Bell (2003: 334).

For our analysis I adopt the classic structure of workgroup research – input, process, and output (Hackman, 1987; Marks, Mathieu and Zaccaro, 2001). In short, the inputs are board composition and tasks (section 2); the process is the board dynamics (section 3); and the outputs are board performance and cohesion (section 4), and I shall finish with thoughts about boards and the future.

I shall take this model's updated version, which is the input – mediator – output (IMO) (Ilgen, Hollenbeck, Johnson, and Jundt, 2005). In the input – process – output model, the behavioural processes are seen as the mediator between the inputs and the outcomes. The processes act as mechanisms that convert inputs into outputs. In the IMO model, the dynamic nature of members' interactions is taken into account and this focuses both on processes and emergent states.

This Element will examine primarily the board of directors within a corporation. Corporations employ thousands of people and their shares are held by the pension funds of the vast majority of individuals within countries. They have huge influence and power in the marketplace and often in their relationships with governments. How these companies are run really matters. Of course, there are organisations which also employ many people and which hold huge sway in national economies, which are not corporations, such as the civil service, the health service, the armed forces and the police, to name just a few. And naturally there are family firms and start-ups, and professional service firms with different governance arrangements. It is highly important that these organisations are governed well too. But the corporate form tends to be the major area of focus for research and policy from where other forms primarily take their lead, and so in this Element, this will be where our attention is centred. Similarly, this is not an Element about *comparative* governance. I shall touch on the merits or otherwise of dual boards that are found in certain countries, and indeed I will advocate that the principle of employee representation, as found in a number of jurisdictions, should be instigated in the UK and the US. But the focus will be on the unitary board of directors. Lastly several

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-97139-3 — Board Dynamics
Philip Stiles
Excerpt
More Information

areas which are important for board behaviour, such as the nature of financial markets, the role of regulators, the disciplinary power of analysts and the media, insolvency law and tax law, the market for corporate control, and executive pay, I can only touch on in the bounds of this Element. Each are deserving of an Element in their own right.

Our next section will focus on the inputs to the board, and examine board composition. This is important since the mix of directors regarding their knowledge, the time they can give to their duties, the weighting between executive and non-executive directors, and the diversity within the board, will all strongly influence the nature and dynamics between board members. For example, if the non-executive directors have very similar demographic attributes to the CEO, this may result in a set of dynamics which may be very different from a board where the demographics were more dissimilar. With board process, how the board conducts itself with regard to meetings, agendas and topics discussed, and how this process is led (primarily by the Chair) will also have significant influence on the dynamics of the board.

2 Board Composition: Setting the Conditions for Dynamics

The fundamental ingredient in board dynamics is the combination of skills, behaviour, knowledge and attitudes of the directors. Like all work groups, the selection of members and the composition of the group overall will have strong implications for the dynamics of the collective. With the movement toward corporate purpose and social impact, this theme has become more important than ever. For example, the 'New Paradigm' states that:

> *'The composition of a board should reflect a complementary diversity of thought, background, skills, experiences and tenures. The board of directors should develop a system for identifying diverse candidates, including women and minority candidates, and for effectively integrating new members into the board dynamic'.* (Lipton, 2019: 43).

The call for greater diversity reflects the need to broaden the thinking within the board to include a longer-term perspective and stronger and more insightful relationships with stakeholders. Recent data suggest that there has been progress in this area.

In 2019 the major headhunting firm Spencer Stuart published their annual Board Index survey and announced that women, and men from minority backgrounds (defined as African-American/Black, Hispanic/Latino or Asian) constituted a majority of the cadre of new intake of directors (Spencer Stuart US, 2019). However, female representation in key roles overall remains poor. In the UK, just 3.3% of Chairs are women and 4% of CEOs (Spencer Stuart UK,

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-97139-3 — Board Dynamics
Philip Stiles
Excerpt
More Information

2019), while in the US, women currently have only 6% of CEO roles in S&P 500 companies (Catalyst, 2020). For ethnicity, the picture is no better; only 5% of CEOs of major firms in the UK and US are from an ethnic minority background and there are no women CEOs who are from an ethnic minority.

So only two cheers for greater diversity on boards. In addition, overall, high-quality board members seem to be scarce, due to a number of factors such as regulatory pressure, concerns about time commitment, and possible reputational risk (Risso-Gill, 2018).

These figures tell an interesting story. After decades of opaque processes of director selection resulting in remarkably similar profiles on boards of directors, things are beginning to improve. But the improvement is very slow and from a very low base. In addition, problems about finding the right talent, and having the right processes to acquire it, remain. This reflects the very thorny nature of board composition and selection.

This is the foundation of board dynamics and also one of the least well understood aspects in corporate governance research. In this section I shall look at these elements and examine what they mean and what the implications are for boards and governance. I organise the section as follows. First, I shall look at board structure, examining key elements such as the difference in governance approaches between countries, the composition of board committees, issues of board size and the requirement for independence. Then I shall discuss the human and social capital dimensions of boards, and introduce ideas on board selection, succession and diversity. Let us begin with the issue of board structure.

2.1 Board Structure

There are two broad versions of board structure: the unitary (or one-tier) board, primarily seen in the UK, USA, Australia and Canada; and the two-tier board, chiefly seen in Asia, mainland Europe and Latin America. The characteristic of the unitary structure is that executive and non-executive directors work together on one board. The unitary board thus would typically include (i) the CEO, who runs the organisation and leads the executive group; (ii) the executive directors; (iii) a Chair, normally a non-executive director, who runs the board of directors; (iv) the independent or non-executive directors; and (v) a senior independent director, (SID), a position introduced following the Higgs report (2002), who is a non-executive director providing a conduit between the board and stakeholders should normal routes of communication between investors and the Chair and/or CEO become problematic, or if a rift occurs between CEO and Chair (Block and Gerstner, 2016; FRC, 2018, IOD, 2018). There is also usually

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE
Cambridge University Press
978-1-108-97139-3 — Board Dynamics
Philip Stiles
Excerpt
More Information

a company secretary, who ensures that the process of the board – the provision of the agenda and the board papers, the taking of minutes and giving advice on procedural issues – are carried out effectively.

Under the UK Corporate Governance Code, at least half of the board (excluding the Chair) should be independent directors, ideally with a diversity of backgrounds (FRC, 2018). The Code also states that the Chair and CEO roles should not be held by the same person, and the Chair should not be a former CEO of the firm. In the USA, which also has a unitary board structure, the CEO tends to be sole executive on the board, with the rest of the board comprising independent directors. Approximately half of boards in the USA have separated the roles of CEO and Chair, with the other 50% having a combined CEO and Chair role (Spencer Stuart US, 2019).

The debate about the merits of splitting the CEO and Chair has a long lineage (Dalton and Dalton, 2011). The arguments for the CEO and Chair positions being held simultaneously by one individual (the CEO duality perspective) is that it provides a unified focus of leadership and this can be reassuring both for managers within the organisation also for external stakeholders. This perspective derives support from work in organisation theory on leadership and legitimacy (Finkelstein and D'Aveni, 1994). Proponents of splitting the roles draw on agency theory to argue that CEO duality may encourage the entrenchment of the CEO, which would dramatically reduce the ability of the board to monitor and discipline effectively (Fama and Jensen, 1983). A further argument against combining the two roles is that they are fundamentally different positions, and joining them in one person risks either task overload or a gap in capabilities, resulting in an ineffective board (Demb and Neubauer, 1992). Numerous studies have sought to determine which structure has the most positive outcomes for corporate performance, but no substantive relationship has been demonstrated (Dalton and Dalton, 2011). Nevertheless, the arguments against CEO duality have generally prevailed and it is only really the USA where a significant proportion of listed companies have the roles combined.

In a two-tier board structure, a management board of executive directors, responsible for the company's strategy and its implementation, is monitored by a distinct supervisory board, comprising non-executive directors, who review the strategy and the overall health of the organisation for shareholders. The supervisory board is responsible for the appointment (and the remuneration level) of the management board members. The supervisory board itself is appointed by the shareholders of the organisation. There is a prohibition against an individual having a seat on both boards (Block and Gerstner, 2016).

The two approaches to board structure largely reflect the pattens of economic and political differences that occur between nations. Research in this area has

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-108-97139-3 — Board Dynamics
Philip Stiles
Excerpt
More Information

been largely informed by the Varieties of Capitalism tradition (Hall and Soskice, 2001), which makes the distinction between Liberal Market Economies (LMEs) and Coordinated Market Economies (CMEs). In LMEs, firms coordinate their activities primarily through ‘‘competitive market arrangements’’ which are ‘‘characterised by the arm’s-length exchange of goods or services in a context of competition and formal contracting.’ (Hall and Soskice, 2001: 8). In CMEs, ‘‘firms depend more heavily on non-market relationships to coordinate their endeavours with other actors and to construct their core competencies.’’ (Hall and Soskice, 2001: 8)

In LMEs, reliance on market-based mechanisms produces a premium on transparency for information, high disclosure, an active takeover market, an active private equity market, and equality of treatment to shareholders. It also emphasises a market relationship between the individual employee and the firm, giving management a high degree of freedom to hire and fire in order to allow the firm to be adaptable.

Share ownership is dispersed in LMEs, and this entails a large degree of shareholder passivity, since each shareholder only has a relatively small stake, which is usually part of a portfolio of other investments, and so the incentive to monitor or be generally involved with an individual company is low. This separation of ownership and control has historically been addressed by an ‘‘arms-length’’ mode of governance which does not rely on direct intervention by shareholders but instead looks to mechanisms such as independent oversight by the board to ensure the interests are alignment between owners and management.

CMEs, by contrast, have a less-dispersed shareholding and are characterised by organisations operating in collaborative complex networks. Ownership is more concentrated, with banks, families and state finance being dominant, and as a result, there is a limited market for takeovers or private equity, and limited disclosure, with the majority shareholders having far better information and benefits relative to minority shareholders. For CMEs, organisations rely much less on finance sourced through equity markets or other publicly available and transparent financial data, and more on credit-financing, sourced through ‘‘dense professional and business networks with strong trust levels that have a more long-term focus’’ (Hall and Soskice, 2001: 9).

The implications for board structure are clear. For CMEs, the presence of large block holders in capital markets brings less liquidity in these markets and increases the incentive for these investors to have direct control, since they cannot disburse their stakes in firms quickly. CMEs tend to have two-tier boards, with the supervisory board including representatives of relationship partners such as banks, suppliers and firms who are working in collaboration.

© in this web service Cambridge University Press www.cambridge.org