The Eversheds Board Report

The effective board

EVERSHEDS

Foreword

By John Heaps, Chairman

The first Eversheds Board Report, published in 2011, provided an insight into the relationship between board composition and share price performance of some of the largest companies across the globe during and after the financial crisis.

Since the publication of our last Board Report, economic conditions have remained challenging; indeed, the directors we interviewed identified the current economic climate as one of the three key challenges they face, together with growth and risk strategies.

Increased media attention has meant that boards have also been subject to greater scrutiny. Balancing strategic growth decisions against a myriad of risk factors and tougher regulation and governance is the challenge for boards in 2013.

Against this backdrop, we wanted to see whether we could provide further insight into what makes an effective board. We have updated and expanded our empirical research and also obtained views from a wide range of senior board members as to what matters most in creating an effective board, their views on shareholder engagement and management of risk.

The data collected for this Report spans an additional three years since our last Board Report so that our analysis covers the years 2007, 2009, 2011 and 2012. We have almost tripled the number of companies under investigation (to 542) as well as the number of directors interviewed. Further information on the methodology is described in the section headed 'Background and research approach'.

The benefit of our quantitative and qualitative analyses is that the data and the views reported show an interesting dichotomy, namely, that often the general trend of what is happening lies in one direction yet the trend in relation to better performing companies lies in another. For example, the trend seems to be to have fewer executives on a board but companies with better share price performance have a higher ratio of executives to non-executives than the regional norm.

Whilst not attempting to be prescriptive, this Report brings out certain characteristics which are common to the most successful companies and our interviews with directors show a remarkable consistency of view in many key areas of boardroom behaviour. We hope that the interesting themes and findings of this Report will make a valuable contribution to the debate on what makes for good governance in the boardroom.

We would like to thank all those who took time to answer our questions and who contributed to the preparation of this Report.

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Glossary

'Control Group' means the 192 companies which were common to both the 2013 Eversheds Board Report and the 2011 Eversheds Board Report. These companies were used to track changes and trends across four time points: 2007, 2009, 2011 and 2012. A breakdown by region is included in the Full Report.

'major shareholder' means a shareholder with more than a 3% shareholding.

'NED' means a non-executive director.

'this Report' means the contents of this report, which is extracted from the Full Report.

'Shareholder Analysis Group' means the sample group of companies researched in greater depth for the 'Shareholders' and 'Risk and committees' sections of the 2013 Eversheds Board Report. Between 138 and 160 companies were included in the different analyses, depending on the public data available. A breakdown by region is included in the Full Report.

'Top 50 Companies' are the top 50 better performing companies from the full sample of 542 companies by share price performance.

'2011 Eversheds Board Report' means the report titled 'The Eversheds Board Report' published by Eversheds LLP in 2011.

'2013 Eversheds Board Report' or the **'Full Report'** means the report titled 'The Eversheds Board Report' published by Eversheds LLP in April 2013, of which this Report is an extract.

Where there is reference to a company being **better performing**, this terminology is referring to better performance by reference to share price.

> This Report summarises the findings and is extracted from the Full Report.
> To obtain a free copy of the Full Report e-mail us at **boardreport@eversheds.com**

Background and research approach

In this 2013 Eversheds Board Report we have once again investigated whether board composition affects the share price performance of some of the largest companies across the globe in the same manner as the 2011 Eversheds Board Report. This time we have compared share price performance based on share price data for a one year period between July 2011 and July 2012, as well as identifying trends in board composition over the five year period from 2007 to 2012. This Report also looks into other issues relating to board behaviours and good governance, including shareholder engagement and risk management.

There are various methodologies for measuring company performance. This Report explores the way in which the composition of the board may have an impact on its company's share price performance. It is important to remember when reading the findings provided by this analysis that these are correlation observations and not necessarily causation factors. We recognise that external factors, such as investor interest in certain sectors at any given time or regional economic conditions, can impact share price irrespective of a board's performance or constitution.

This Report is based on two lines of investigation:

- The first is a quantitative investigation into board composition factors and how they relate to share price performance to see if patterns emerge as to the characteristics of boards of successful companies. This investigation was carried out by independent research company RSG Consulting Limited ('RSG') who designed and conducted the research and analysed the findings to compile this Report.
- The second is a qualitative investigation which involved face-to-face interviews with 80 senior directors conducted by Eversheds' partners experienced in corporate governance and by senior RSG consultants. This Report reflects the views which emerged from these interviews on aspects of board composition and behaviours, characteristics of effective boards, shareholder engagement, management of risk and the purpose and function of board committees.

In this Report, 542 of the world's leading companies were investigated, almost tripling the number examined for the 2011 Eversheds Board Report. We also extended the international coverage. It included a close analysis of the boards of the top 100 companies in the UK, Europe and the US, over 120 Asia-Pacific companies, 50 Middle Eastern companies and 30 companies from Brazil. In the quantitative investigation, the characteristics of over 6,000 directors at these companies were examined.

In the qualitative investigation, personal interviews with directors involved discussions about the real challenges and issues facing board directors today. Unless otherwise stated, the opinions expressed represent the commonly held majority views of these directors.

To avoid the analysis being unduly influenced by the comparative performance of economies of different regions (see graph below), the objective analyses were run within each region and country, to test for consistent patterns. Share price figures were taken from the first trading day of July in 2007, 2009, 2011 and 2012 to show share price changes over the past one, three and five years.

In most regions there is now a considerable body of law, regulation and institutional guidance which is directed at board composition and governance. This Report does not attempt to analyse the way in which law and regulation is evolving and the impact that it is having on board composition.

Banking and financial services companies in the sample (comprising 117 companies) have been examined separately from other companies due to the exceptional nature of the difficulties which they have experienced and because they tend to have different board characteristics.

Share price changes across regions (2007–2012)

The chart below shows share price changes over the past one, three and five year periods for the full sample of companies in each region, taken on the first trading day of July in each year. Companies in the Asia-Pacific sample had the lowest share price variation of less than 1% (-0.6%) for the five years from 2007 to 2012.

Our key findings

Smaller boards tend to deliver better share price performance.

Having more executive directors on the board than the regional average is related to better performance.

Companies with a better share price performance tend to have a greater number of major shareholders.

Companies performed better with a serving CEO as one of the non-executive directors.

Diversity in its widest sense has risen up the board agenda. Most directors now say diversity on the board is key to good board performance. The empirical data shows that having NEDs with experience in a different sector is related to better company performance.

Whilst the average age of directors is increasing, better performing companies tend to have younger directors.

Chairman's leadership is crucial to set the tone of the board to drive the company's culture and values and to ensure its integrity.

The media have over-stated the 'shareholder spring'. Positive dialogue between shareholders and boards is more evident. The average AGM approval rating for executive remuneration packages was over 90%. The exception was the US where it was 80.5%.

Risk strategy is now higher on the board agenda than before and a board's key challenge is how to balance growth and risk.

Board characteristics of successful companies

The board characteristics which have emerged in this Report as having a positive relationship to share price performance are set out below.

2013 Findings

Characteristics of companies with strong share price performance (2011–2012)

Ratio of NEDs to executives
A higher proportion of executives to NEDs

Diversity of industry experience
Higher percentage of NEDs with different industry sector experience

Age
Younger average age of directors

Major shareholders*
Greater number of major shareholders

Board size
Lower number of directors

**Major shareholder correlations were run on the Shareholder Analysis Group (as defined in the Glossary)*

Themes that have emerged from our latest findings include:

- **Ratio of NEDs to executives:** Companies with a higher ratio of executive directors to NEDs when compared with the regional norm tended to have a better share price performance. Companies with a serving CEO as a NED also showed a better share price performance. This relationship is less evident as a positive correlation in this Report when compared to the 2011 Eversheds Board Report, which could be due in part to the reducing number of CEOs now serving as NEDs. It may be that having more executive directors on the board in a NED role provides a slightly greater emphasis on an ‘executive mentality’. A number of directors interviewed made the point that too many NEDs can focus on corporate governance matters to the detriment of the assessment of the implementation of board strategy. Having more executives or NEDs who are serving CEOs or ex-CEOs can help the board focus on strategy.
- **Diversity of industry experience:** Sector diversity also emerged as having a positive relationship to share price performance. In particular, companies who had more directors with experience from the same industry sector showed a worse share price performance than companies with directors having a diversity of industry experience. This finding dovetails with directors’ views that experience from a different industry sector is the key diversity factor that can impact better board performance.
- **Age:** The most successful companies sampled tended to have slightly younger directors. This runs contrary to the trend that directors are, on average, getting older. The directors interviewed believed that diversity of age and generation in the boardroom was growing as an important factor in a board’s performance.

The board characteristics which were shown to have a positive relationship to share price performance in the 2011 Eversheds Board Report are shown below.

2011 Findings

Characteristics of companies with strong share price performance (2007–2009)

Board size
Lower number of directors

Major shareholding
Higher % of shares held by substantial shareholders

Women
Higher percentage of female directors

Independence
Higher percentage of independent directors

Tenure
Directors serving longer terms

Serving CEOs as NEDs
More directors who serve as CEOs of other companies

Holding consistent across both Reports was the impact of board size and major shareholders. In both Reports, companies with smaller boards had a better share price performance, as did companies with either a greater number of major shareholders or major shareholdings held by substantial shareholders.

Interestingly, and surprisingly to some, two characteristics which appear to have less of a relationship with share price performance in this Report compared to the 2011 Eversheds Board Report are having women on the board and independence of directors. For both of these characteristics, the data indicates that boards are moving to a more globally consistent standard. Accordingly, the variables in the data are less distinct which means that it is more difficult to isolate these characteristics as having a particular relationship to share price performance.

In addition, the much wider international scope of the companies investigated for this Report means that the results have been influenced by the culture, legal requirements and regulatory regimes of different regions to a far greater extent than those shown in the 2011 Eversheds Board Report. If the results of this Report were limited to UK companies, then the characteristics of board composition having most effect on company share price performance would be broadly similar to those identified in the 2011 Eversheds Board Report.

Regional findings of best performing companies

The table below shows board characteristics of the most successful companies sampled in each region. For these purposes, the top 20% of companies in each region were taken and all figures shown are averages for those companies.

In addition, a table showing a more detailed breakdown of the correlations of board characteristics for companies with stronger share price performance by region is at page 12.

Best performing companies (top 20% of our sample by region)

Region/Country	Number of companies in top 20% of region	Board size (number of directors)	Director age	Number of female directors	% female directors	% independent directors	Number of executives on board	% NEDs	% NEDs with same industry experience	Number of serving CEOs as NEDs	Number of external appointments per director
Asia-Pacific	**25**	**11.4**	**61.0**	**0.9**	**9%**	**49%**	**3.7**	**63%**	**28%**	**0.9**	**1.9**
Australia	5	10.0	61.1	1.8	18%	74%	1.8	83%	27%	0.2	2.2
Hong Kong	4	12.0	53.2	0.8	6%	26%	4.5	35%	13%	1.5	1.3
India	9	12.7	64.6	0.4	3%	56%	2.7	78%	48%	1.1	3.0
Japan	7	10.5	62.0	0.8	10%	37%	5.8	48%	17%	0.7	0.6
Europe	20	12.6	58.5	2.6	20%	46%	1.6	83%	29%	1.9	2.0
Middle East	12	8.4	51.8	0.0	0%	31%	1.1	34%	14%	0.5	0.8
Brazil	6	10.5	58.5	0.0	0%	44%	1.8	82%	31%	0.8	1.1
UK	26	9.7	56.6	1.5	14%	60%	3.1	65%	25%	0.7	1.5
UK FTSE 100	20	10.6	56.6	1.6	14%	60%	3.5	67%	25%	0.8	1.4
UK FTSE 250	6	6.7	56.8	1.0	13%	60%	1.8	60%	23%	0.3	1.8
USA	20	11.8	60.8	2.5	21%	73%	1.6	87%	20%	2.8	1.8
ALL	109	10.9	58.8	1.5	13%	54%	2.4	70%	24%	1.3	1.6

The changing composition of the board

To chart the real changes in board composition, a Control Group of 192 companies (as defined in the Glossary) was examined over a five year period (2007, 2009, 2011 and 2012). The study demonstrated certain global trends in board composition which are set out below. In addition, our interviews with directors also gave some important insights into these trends.

- **Smaller board size:** Over the past five years, companies in most regions have moved towards a smaller board size. There has been a significant (8%) decrease in the average number of directors on the board over the past five years. In 2007, the average board size was 13.4 directors; in 2012 it was 12.3 directors for the 192 companies examined. The majority of board directors interviewed, including those who served on two-tier boards in Europe, believe that an effective board should have less than 12 members.

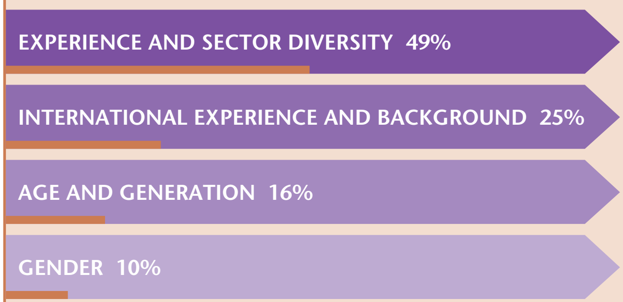
- **Executives on the board:** The number of executives on boards decreased for all regions. The overall average decrease was 34% (from an average of 3.2 executive directors in 2007 to 2.1 in 2012). The largest decrease was in Europe (60%) and the smallest decrease in Australia (8%).

- **Combating 'group think' in the boardroom:** The approach to diversity for most directors interviewed has significantly moved on since the 2011 Eversheds Board Report. Directors interviewed were asked what kind of diversity has the most effect on board performance and the results are shown in the diagram opposite. The majority of board directors (61%) now believe that diversity in its widest sense has the most effect on board performance. By this they mean diversity of skills set, expertise outside of industry sector, international experience, age and background, as well as gender. Diversity is recognised as being a wider issue than gender in order to combat 'group think' in board decision making. In particular, having more directors on the board with experience of a different industry sector is related to better company performance.

  - **More women on boards:** In response to more lobbying for gender equality, most companies investigated have made a move to increase the number of female directors on their boards. However the numbers can be misleading. The seemingly large increase (50%) in the proportion of female directors across all regions over the past five years is against a low base. In reality most boards have either appointed one, or gone from one to two female directors. There is still more work to be done on gender diversity, particularly as this increase has largely been on the NED side rather than executive appointments. Between 2007 and 2012, the largest increases were in Europe (156%) and Hong Kong (133%). Our interviews with directors suggest that there is little evidence of support for quotas for women on boards.

  - **Age:** Overall, the average age of company board directors has now increased to 60 from 58 in 2007. The average age of directors in the Middle East was the youngest (average age 55 years) and oldest in Japan (average age 63 years). However, there is a positive correlation between younger directors and better share price performance, a relationship that held true in the FTSE 100, the US, Europe, India, Brazil and the Middle East.

Directors' views on the kind of diversity that has the most effect on board performance



- **Tenure:** Directors are tending to be in their roles for longer. The global average tenure of directors of the companies sampled is 6.7 years on the board, an increase of 13% over the last five years. While the relationship between share price performance and length of tenure is weak in the short-term, there is a positive relationship between longer tenure and share price performance over three and five year periods.

The majority of board directors interviewed, including those who served on two-tier boards in Europe, believe that an effective board should have less than 12 members.

Are boards doing the right thing?

The quantitative analysis shows the characteristics of boards of better performing companies. The research into board composition and interviews with directors reveals that, in practice, boards are moving away from some of these beneficial characteristics. The following table highlights some of the key divergences between what is happening and what appears to be connected to better performance.

When trends are referred to in the second column entitled ‘What is happening?’, these trends are observations based on a review of the companies in the Control Group.

	What is happening?	BUT	What is best?
Ratio of executives on the board	The trend is to have fewer executive directors on the board. There was an average of 3.2 to 10.2 executives to NEDs on the board in 2007, compared to 2.1 to 10.2 executives to NEDs in 2012.	BUT	Companies with a better share price performance showed a higher ratio of executive directors to NEDs. The Top 50 Companies (as defined in the Glossary) had a ratio of 2.4 to 8.2 executives to NEDs, or 22.3% executives on average.
Diversity of experience for NEDs	There appears to be a growing trend of appointing more NEDs with the same industry sector experience since 2007.	BUT	Companies whose boards had a higher proportion of NEDs with the same industry sector experience had a worse performing share price in the July 2011/2012 year period, so diversity of sector experience for NEDs is better for boards.
Serving CEOs as NEDs	There are now fewer active serving CEOs as NEDs, with numbers dropping by just over 60% since 2009. The regional exceptions to this are the FTSE 250 and Australia where the number of serving CEOs as NEDs has increased.	BUT	The research for the 2011 Eversheds Board Report showed that having a serving CEO as a NED has a positive relationship with the share price performance of a company, other than in India. This is borne out in the research for this Report. In Australia where the number of serving CEOs as NEDs has increased, companies which had a serving CEO as NED had a better share price performance.
Average age of directors	The trend since 2009 is to have older directors across all boards. The average age of all directors in the 542 companies examined for this Report is 60.	BUT	Younger directors appear to be driving better performance for their companies. The chairmen and CEOs of the Top 50 Companies were two years younger than the average.

The effective functioning of the board

The interviews with senior directors have provided a context to the issues behind the statistics highlighted in this Report. This section represents the views of experienced directors as to best practice in the boardroom and the increasing burden on directors.

- **Chairman's leadership is crucial:** Directors were virtually unanimous that the role of the chairman continues to be of vital importance to effective board functioning. There are signs of the chairman's role expanding to engage with a wider variety of stakeholders at a deeper level. Half the directors interviewed (51%) thought that chairmen could enhance the way in which they engage with different stakeholders because they are the pivots around which relationships with the CEO and other board members revolve. Many directors pointed out that the chairman (as well as NEDs) were increasingly interacting with 'Tier 2' management, shareholders, media and in some cases, customers.
- **Increasing burden on directors:** Whilst the duties of directors have not changed, NEDs and chairmen seem to be feeling a greater burden of responsibility in the last two years, whether this is because of the difficult economic climate, increasing regulation or the greater focus by boards on risk. Media focus on certain matters means that NEDs and chairmen take their duties extremely seriously, often spending far more time on board matters than their contract requires. The value given by NEDs invariably exceeds their remuneration and many take on the roles for job satisfaction and not for money. Reputational risk is regarded as fundamental by senior directors and many who were interviewed, including those with financial sector expertise, were reluctant to accept appointments to boards of banking or financial services companies for this reason.
- **Independence:** Having more independent directors has a positive relationship with share price performance in developing markets but less so in mature markets, such as the UK, where the concept of independent directors is well established. Many directors interviewed commented on the need for "independence of thinking", by which they meant that it is important for NEDs ultimately to be able to walk away from their role if they are unhappy with decisions.
- **Cultural integrity is a board issue:** Many directors considered that the chairman determines the culture of the whole board. Given the current emphasis placed on adhering to the values of integrity and trust in an organisation, having the right culture to foster these and other company values must start in the boardroom.

Directors were virtually unanimous that the role of the chairman continues to be of vital importance to effective board functioning.

Shareholders: active or more engaged?

Given the amount of media attention focused on activist shareholders, we analysed the level of shareholder engagement of the Shareholder Analysis Group (as defined in the Glossary) and sought directors' views on whether shareholders were becoming more active or simply better engaged with their companies.

- **Major shareholders:** Companies with a greater number of major shareholders (holding more than 3% of the issued shares in a company) tended to display a better share price performance, particularly for companies in the US, the UK and Hong Kong. This was also a key finding in the 2011 Eversheds Board Report and continues to hold true over a five year period.
- **The 'shareholder spring' is over-stated:** Much has been written about the so-called 'shareholder spring'. The idea of a group of activist shareholders has grabbed the media interest. However, the research would appear to contradict this perception. Only 14 companies out of 140 analysed received less than 80% shareholder approval for their executive remuneration packages. What can be said is that the relationship between the board and its shareholders is changing, with increasing dialogue between them. The majority of directors interviewed recognised that shareholder engagement is having an impact on board strategy and remuneration.
- **Positive engagement and meaningful dialogue:** Whether or not shareholders have become more activist in behaviour, directors were of the view that the relationship with shareholders is changing and dialogue between them has been increasing. Directors believed these interactions are largely positive and recommended early engagement on difficult issues. In fact, one of the reasons directors gave for the high approval ratings for remuneration reports was the prior proactive dialogue between the board and shareholders. In the UK, companies with more engaged shareholders (as measured by the percentage of votes cast on resolutions) had a better share price performance.
- **Alignment within shareholders:** Directors would welcome better alignment between the governance and fund management arms of institutional shareholders as some directors expressed concern that they received conflicting views between the two.

The relationship between the board and its shareholders is changing, with increasing dialogue between them.

What is best practice in engaging with shareholders?

We asked directors to outline their opinions as to how companies and shareholders can best engage with each other. The top three best practice suggestions were:

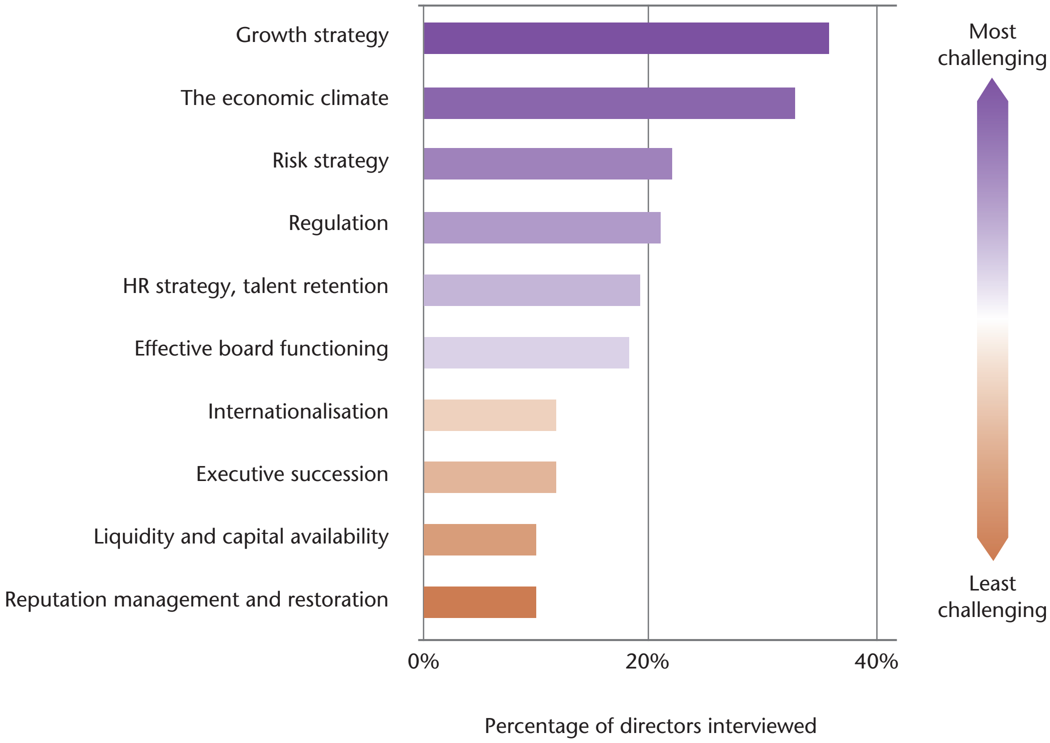
1. Proactive communication with shareholders from the CEO and Chair, or Chair of the Remuneration Committee, depending on the issue.
2. Provide clear explanations through personal visits and logical presentations. Where the company deviates from market norms, a clear argument needs to be put forward to the investors as to why the company has chosen an alternative route.
3. Ascertain if the corporate governance team at a relevant institutional shareholder is aligned with its analysts or fund managers, with whom the company is in dialogue. If not, take appropriate action.

Board challenges and changing attitude to risk

A developing theme in the 2011 Eversheds Board Report and continuing in this Report has been the changing approach to risk, which appears high on the board agenda.

- **Top three challenges:** Directors were asked what the top three challenges facing their boards were and the graph below sets out the directors' responses.

What are the top three challenges currently facing your board?



- **Approach to risk:** Companies now, across all jurisdictions, are more pro-active and positively focused on risk and risk management. This emerged when directors interviewed cited balancing growth strategies and risk as key challenges for boards. The majority of directors interviewed (72%) said that their board's approach to risk had changed in the last two years with risk being much higher on the board agenda.

Companies now, across all jurisdictions, are more pro-active and positively focused on risk and risk management. This emerged when directors interviewed cited balancing growth strategies and risk as key challenges for boards.

- **Risk committees:** Other than those companies (generally in the banking and financial services sector) who are required for regulatory purposes to have a risk committee, the trend is still for risk to be the remit of the audit committee. The majority of directors were not in favour of separate risk committees.

2013 Regional findings

Correlations between board characteristics and stronger share price performance by region (based on share price movement in the one year period from July 2011 to July 2012)

US Companies in sample: 100	UK FTSE 100 Companies in sample: 99	EUROPE Companies in sample: 102	MIDDLE EAST Companies in sample: 57	ASIA-PACIFIC Companies in sample: 122
Major shareholding* Higher % of shares held by substantial shareholders **Major shareholder*** Greater number of major shareholders **Gender** Higher percentage of female directors **External executives as NEDs** More directors who serve as executives of other companies **External appointments** Lower number of external appointments held by each director **Age** Younger average age of directors **Industry experience** Lower percentage of NEDs with same industry sector experience	**Major shareholder*** Greater number of major shareholders **Executive directors** Greater number of executives on the board **NEDs to executive ratio** Lower percentage of NEDs **External appointments** Lower number of external appointments held by each director **Age** Younger average age of directors **Major shareholding*** Lower % of shares held by substantial shareholders **Industry experience** Lower percentage of NEDs with same industry sector experience	**Board size** Smaller number of directors **NEDs to executive ratio** Lower percentage of NEDs **Industry experience** Lower percentage of NEDs with same industry sector experience **Age** Younger average age of directors	**Age** Younger average age of directors **NEDs to executive ratio** Lower percentage of NEDs **External appointments** Lower number of external appointments held by each director **Industry experience** Lower percentage of NEDs with same industry sector experience **External executives as NEDs** Fewer directors who serve as executives of other companies **Board size** Lower number of directors	**Industry experience** Lower percentage of NEDs with same industry sector experience

**Correlations for major shareholders and major shareholdings were run on the Shareholder Analysis Group.*

***Note**: for the above aspects of the research, the FTSE 250 and Brazilian companies in the wider sample group were not included.*

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