The Board of Directors: Regulation and the Role of Boards

Global Edition
Introduction

There is wide consensus that building a strong board of directors is integral to a company's performance and long-term success. Effective boards contribute strategic counsel, performance oversight, legal compliance, and ethical standards. Armed with this guidance, companies benefit from strong financial performance, talent attraction and retention, and potentially industry leadership. However, amidst high-profile board scandals, regulatory demands, activist investors, and constant media scrutiny, the goal of assembling a strong board has perhaps never been more elusive. Directors now face heightened pressures, complicating the role and obscuring the path to success.

What are the challenges and areas of opportunity in this changing landscape? What are the implications for today's CEOs and boards of directors? What is the state of regulation and what are the impacts? How can boards thrive under these circumstances? These questions loom as companies, CEOs, and boards work to navigate today's corporate environment and achieve success.

In this edition of Executive Monitor, Boyden will unpack the pressures facing boards of directors, and explore areas of opportunity. Drawing upon secondary research and in-depth interviews with Boyden partners and industry executives, we will examine recent shifts, perspectives on the state of regulation, and important board assembly considerations for effectively managing the most pressing challenges in corporate governance.

The Board of Directors and the CEO

The relationship between the board and the CEO is one of the most important determinants of a company's success. To forge a successful relationship, both the board and the CEO should have a clear understanding of each party's role, requirements, and limitations. Eleanor Bloxham, Founder and President of The Value Alliance agrees, explaining that "the board is responsible for determining the strategic vision and the CEO is tasked with executing on that vision. The two entities must understand their respective realms."

To ensure this separation of powers, Bloxham notes, "The board should create descriptions detailing the duties of the CEO and those of the board. These guidelines should be clear and allow for no overextension on either end." The CEO of a well-known global company and board member of three other publicly listed concerns told Boyden, "The more that the board is removed from day-to-day business operations and functioning as an independent oversight committee, the stronger the company’s financial performance will be."

This firm division of responsibilities will only be successful if the CEO and the board have shared goals. The two parties must agree upon their priorities and the timing of those priorities, leaving the board to accomplish the strategic element and the CEO to execute on the managerial component. To reach a state of shared goals and agree upon corporate priorities, the CEO and board must engage in candid, constructive communication marked by mutual respect.
Past Scandals and Management Overextension

Though the ideal relationship between the board of directors and the CEO is grounded on the principle that each party tends to their respective obligations without influencing the realm of the other, modern history is rife with examples of overextension.

In the instance of Enron in the early 2000s, management played an outsized role in running the company and the board offered insufficient oversight and guidance. In this outsized role, management employed schemes to hide the company’s losses and feign profitability. Soon, analysts began to question Enron’s earnings and transparency practices, leading to downgraded earnings and, later, an SEC investigation. Ultimately, on December 2, 2001, Enron filed for Chapter 11 bankruptcy protection.1,2,3 In the 2002 WorldCom scandal, management similarly overreached while the board retreated. In late 1999, WorldCom’s revenue had begun to decrease as companies cut spending on telecommunications services and equipment. To hide its losses, WorldCom enlisted irregular accounting practices, later revealed by an internal audit. Subsequently, in July of 2002, WorldCom also filed for Chapter 11 bankruptcy protection.4,5

While high-profile fraudulent corporate accounting activity was rampant in the early 2000s, similar scandals have emerged over the past couple of years. In September 2015, Volkswagen (VW) was accused of rigging emissions software to enable diesel cars to pass strict emissions tests. In the wake of the news, the company’s stock price plummeted, causing the share prices of other car manufacturers to fall as well. Following the German corporate model, VW had a split board, consisting of a supervisory board and a management board. Between these two entities, VW retained a 20-person council of directors, evenly divided between shareholders and VW executives, most of whom were German or Austrian. The council included only one truly independent voice. In evaluating VW’s corporate governance, Hans-Christoph Hirt, a director of Hermes Equity Ownership Services, an adviser to pension fund investors in companies including VW, observed, “VW’s supervisory board is short of people with relevant experience and skills and – significantly – independence.”6 Their unwieldy size and lack of independence rendered the boards largely ineffective, unable to provide the company with critical checks and balances that may have entirely prevented the diesel scandal.7,8

The cases of Enron, WorldCom, and Volkswagen demonstrate the risks associated with management overextending and boards of directors playing relatively minor roles in overseeing corporate performance. Thomas Flannery, Managing Partner of Boyden United States, explains that “in these instances, where companies were seeing strong financial results, the value of stock was climbing, and companies were seemingly functioning well, board members found it difficult to step in and enforce integrity. This provided management with a broader reach, minimal oversight, and ultimately paved the way in some cases for unmonitored unlawful behaviour.”

Resulting Regulation and the Modern Model

Following the corporate scandals of the early 2000s, regulation was introduced expanding the requirements of public companies’ boards of directors, management, and public accounting firms. “These new regulatory frameworks were designed to ensure the board’s independence, extend the board’s oversight function, and place parameters around the reach of management,” explains Boyden’s Flannery. “In doing so, these regulations were intended to protect against the management overreach that occurred in the corporate scandals of the early 2000s, keeping management focused on operations and execution and the board on oversight and monitoring.”
Changes to the Landscape

In addition to regulatory changes, such as those introduced by the Sarbanes-Oxley and Dodd-Frank Acts in the U.S., other types of changes have further broadened the responsibilities of boards of directors. “Amidst these changes, board service is no longer constrained to meeting once every two months or so,” explains Cindy Baerman, CEO at Executive Advisory Services. “Rather, board members are now almost always on call and engaged in continued communication and feedback.”

Social Media

It is estimated that the number of worldwide social media users reached 2.34 billion in 2017 and is expected to grow to approximately 2.95 billion by 2020. Every second sees approximately 6,000 tweets, corresponding to over 350,000 tweets per minute, 500 million per day, and approximately 200 billion per year. The ubiquity and speed of social media mean that it can have rapid, damaging impacts on a company’s reputation. If a company is thought to be operating in an unfair or unethical manner, its public perception can shift through social media at a rate never before seen. “In this social media landscape,” notes Executive Advisory Services’ Baerman, “an issue can hit Twitter on Monday and by Wednesday there may be changes implemented at the CEO or board level.”

In this era of a constant flow of news rapidly affecting public perceptions, boards of directors must be ready to act quickly. Since breaking news can change perceptions in an instant, boards are tasked with continually considering the reputational risks that arise on social media, the company’s strategy for mitigating these risks, and tactics for monitoring references to the company on social media.

Activist Investors

The past several years have also seen significant growth in the number of activist investor targets as economies have recovered from the Great Recession. According to Schulte Roth & Zabel’s 2018 Activist Investing Annual Review, the number of companies publicly subjected to activist demands has steadily increased from 570 in 2013 to 616 in 2014, 744 in 2015, 843 in 2016, and 805 in 2017. Additionally, Lazard’s 2017 Activism Year in Review report demonstrates a record amount of deployed capital in 2017. Throughout the year, 109 activists engaged in 194 campaigns globally, deploying $62 billion, more than double the total capital deployed in 2016.

While most activist investors are in the United States, new firms have emerged across the globe, in Australia, Canada, Europe, Hong Kong and elsewhere. Often collaborating with pension-fund managers, they leverage trillions of dollars and shareholder proposals to address corporate governance practices and strategies that are thought to inhibit growth.

The growing influence of activist investors has vast implications for boards. Traditionally, they rarely interacted directly with shareholders. Beyond meeting the largest shareholders at annual meetings, boards of directors typically relied on reports from the company’s investor relations department to understand shareholders’ primary concerns. With the growth of investor activism, however, board members more frequently and meaningfully engage with shareholders. In fact, Mary Jo White, Chair of the U.S. Securities and Exchange Commission, recently classified shareholder relations as a board responsibility, saying, “The board of directors is – or ought to be – a central player in shareholder engagement.” As a result, several boards have implemented shareholder liaison committees to manage this growing responsibility. As Cindy Baerman of Executive Advisory Services contends, “Board responsibility and accountability have continued to increase amidst increasing pressure from activists. Directors must now almost daily consider the demands and concerns of shareholders in their work as board members.”
Implications for Today’s Board of Directors

Following the corporate scandals of the early 2000s and subsequent regulatory changes, and amidst social media’s constant news stream and mounting pressure from activist investors, board members’ responsibilities have steadily expanded. Boards must now exercise broader oversight, enforce compliance with stricter regulatory guidelines, and remain constantly aware of the landscape in an environment of heightened exposure.

While there is wide consensus over the ways in which these changes have fundamentally shifted the role of board members, opinions vary over the ideal state of regulation and the most important functions of the board.

Optimism over Regulation

One widely cited opinion concerning the ideal state of regulation expresses satisfaction with strict regulation surrounding compliance and the associated impact on boards of directors. The Value Alliance’s Bloxham explains that without adequate guidance around the oversight boards must provide, boards often provide insufficient counsel. "In these instances, boards do not address issues when they should. This lulls all parties into a false sense of security where issues are not addressed or prevented. Ultimately, crisis situations are created and before long they come to the fore with damaging implications for all parties involved."

George Chavel, currently a Director on the boards of C.H. Guenther & Son, Giant Eagle, Valet Living and World Kitchen, Inc., and former President and CEO of Sodexo North America and Sodexo Healthcare Worldwide, also expressed optimism over the impact of current regulations on the role of boards. "Over the past 10 to 15 years, the board has evolved from a ceremonial function to an entity heavily monitoring corporate functions and dynamics, to a party that is leading the company where necessary and partnering where appropriate. This evolution has been critical as ceremonial board activity does not function well and leaves the company exposed and vulnerable," explains Chavel.

As Boyden’s Flannery notes, “The integrity of the company ultimately boils down to board independence. This independence is a direct result of regulation, which is ultimately in place to protect the shareholders.” Regulation thereby benefits all stakeholders, ensuring board independence and maximizing shareholder value.

Scepticism over Regulation

In contrast, many believe that the current state of regulation is too far-reaching, resulting in unintended negative consequences. Richard Corgel, Managing Member of Cross-Current Consulting, LLC notes that “in some instances, today’s levels of regulation actually inhibit innovation, creativity, and appropriate growth. I think we all understand the need for some degree of regulation to prevent abuse,” he continues, “but I think regulation has gone too far in a number of circumstances.” Additionally, several analysts suggest that the high demands of regulation and the resources invested in compliance can undermine investments in corporate health, growth, and shareholder value.

Allan Marks, Managing Partner of Boyden Australia, adds, “As board members have become more exposed to scrutiny, many are wary of joining public boards. People have begun to feel uncomfortable with the vast responsibility and are increasingly reluctant to assume the liability associated with the role.” As a result, offers Armin Meier, Managing Partner of Boyden Switzerland, “It has become more challenging to attract good board members.” John Byrne, Managing Partner of Boyden Chile, agrees: “The supply of board members has decreased as the board’s exposure and responsibilities have increased. People are now more diligent and thoughtful before joining boards.”
Industry Spotlight

These different perspectives on the appropriate levels of regulation and the effect of today's regulatory landscape on boards of directors are most apparent when viewed through the lens of the financial services and technology industries.

Perspectives on Regulation in the Financial Services Industry

Many in the financial services industry are in favour of strict regulation governing the actions of companies and the oversight mechanisms of boards. Magdy El Zein, Managing Partner of Boyden UAE, explains the benefits of regulation in the financial services industry, saying, “The financial services field is the bloodline and the lifeline of business globally, supporting the growth of all other fields. A threat to the health and stability of the financial services industry inherently endangers other industries as well. Financial services should therefore be the subject of intense scrutiny and regulation.”

Cross-Current Consulting, LLC’s Corgel, on the other hand, notes the drawbacks of regulation in the financial services industry. “Sometimes regulation puts stress on the board of directors and management, complicating the business model. In the financial industry, the plethora of regulation has, at times, produced circumstances where business operators have trouble meeting regulatory expectations. As a result, boards are forced to devote time, energy, and resources toward regulatory maintenance at the expense of strategy development. In this way, regulatory demands put growth and innovation at risk.”

Perspectives on Regulation in the Technology Industry

When it comes to the technology industry, there is wide agreement that regulation has not yet caught up with the pace of technological growth. “Regulatory legislation is never a first mover,” observes Bloxham. “Regulation is reactive and is always late to the game, implemented in response to issues and conflicts.” Agreeing on the reactive nature of regulatory direction, Boyden’s Flannery suggests that the industry must be carefully monitored during its next phases of growth. “If company directors effectively manage the industry’s growth, there will not be a need for a great deal of regulation. If, however, dangers and risks emerge, regulation will need to be implemented.”

The Increasing Importance of Board Skills and Composition

While opinions vary over the appropriate levels of corporate regulation and the impacts on boards of directors, there is wide agreement that with the appropriate skills in place, boards can ultimately self-regulate. It is therefore imperative that board members possess the ability to communicate clearly, confidently and effectively, in a manner that invites discussion and elicits feedback and varying opinions. The resulting discussions will allow boards to naturally explore issues from all angles and arrive at decisions informed by strategic thought and varying viewpoints.17

In addition to effective communication, board members must possess a variety of functional skills and areas of expertise. Karen Kosiba Edwards, Partner of Boydun United States, explains that “years ago, it was ideal to have a board of exclusively CEOs. However, the world is moving so fast now that knowledge quickly becomes outdated. For this reason, it is critical to have a variety of functional expertise in the boardroom to provide insight on the ever-changing landscape.”

Board members must also have a strong sense of self-awareness and deep understanding of their personal strengths and weaknesses. Armed with this insight, board members can more effectively lead, speak up, and collaborate on relevant issues as well as observe, learn, and defer to others where appropriate. This creates a strong and steady exchange of knowledge and ideas, ultimately ensuring that directors learn from one another and the best ideas are implemented.
Perhaps most important in assembling a cohesive, complementary board of directors is a propensity for independent thinking. Individual directors should bring unique thoughts, perspectives and experiences to the boardroom. By giving voice to diverse opinions, boards will avoid groupthink and benefit from broader, more nuanced assessments. Considering a variety of angles and arguments will allow boards to stay several steps ahead of changing circumstances, anticipating challenges and capitalizing on opportunities.

While there is little consensus over the appropriate level of corporate regulation and the implications for boards of directors, there is broad agreement that directors must bring a range of skills, experiences, and ideas that invite discussion, dissension, and opposition. In voicing these opinions and engaging in meaningful conversations, boards will inherently regulate themselves, calling issues into question and examining ideas from all angles. Functioning as a healthy and active governing body, boards will ultimately arrive at the most promising, innovative, yet compliant solutions.

Regional Nuances

Throughout the world, corporate boards function according to varying structures and models. As a result, some meaningful differences exist in board structure from one country to the next. The United States uses a one-tier model, where a single, unified board executes managerial and supervisory responsibilities. The CEO often sits on the board of directors, serving as the sole representative of the company’s executive team. Approximately 50% of boards designate the CEO as the board chairman, while the other 50% enforce a separation between the chairman and CEO roles. The remaining board members are generally independent directors and, according to the New York Stock Exchange, have “no material relationship with the listed company.” Most public company boards have between eight and 12 board members, and the average board size on the S&P 500 is 10.8. The one-tier board structure is thought to promote communication and efficiency.

Many European and Asian countries, however, use a two-tier structure, including both a management board and a supervisory board. Led by the CEO, the management board meets frequently and handles operational decisions. The supervisory board, on the other hand, oversees the management board and handles strategic planning. Members of the supervisory board are elected by shareholders, and a chairman presides over the board. The two-tier model is designed to prevent conflicts of interest and distribute power across many parties.

The Future of Boards and Regulation

Following the high-profile corporate fraud scandals of the early 2000s, regulations were implemented to limit the reach of management and ensure effective board oversight. These regulatory changes broadened and added structure to the board function, more clearly defining the position of the board relative to that of the CEO. In recent years, the role of boards of directors has further expanded amidst the growing pervasiveness of social media and heightened pressure from activist investors. Perspectives vary over the impact that these changes have had on the nature of the board, with some arguing that current regulations and pressures have finally ushered in an era of effective board oversight, and others contending that these changes leave directors vulnerable to scrutiny and liability, making the role less desirable and thus harder to fill.

While there is little consensus over the appropriate level of regulation, there is broad agreement that with an appropriate and balanced skillset, boards will inherently self-regulate. Enriched with independent thought, effective communication skills, functional expertise, and self-awareness, board discussions will be balanced, thoughtful, and exploratory. Board members will intuitively act in the spirit of integrity and moderation, and solutions that would otherwise be encouraged through regulatory oversight will naturally result, leading ultimately to corporate success and growth.
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6. https://www.ft.com/content/e816cf86-6815-11e5-a57f-21b88f7d973f

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