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THE ART AND SCIENCE OF ENHANCING BOARD EFFECTIVENESS

CLARE CHALMERS LIMITED

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**RESPONSE TO FINANCIAL REPORTING COUNCIL**

**CORPORATE GOVERNANCE CODE CONSULTATION**

**SEPTEMBER 2023**

Clare Chalmers Ltd is a provider of board evaluations, working most frequently with FTSE-listed and financial services companies. In the last three-year cycle, we worked with boards of 25 FTSE-listed companies. [REDACTED] of Clare Chalmers Ltd, have reviewed the consultation materials and below are our responses to those questions to which we feel best-placed to respond. We also provide a small number of additional comments at the end.

**Q4: Do you agree with the proposed change to Code Principle K (in Section 3 of the Code), which makes the issue of significant external commitments an explicit part of board performance reviews?**

We agree external commitments should be covered but not as part of a board performance review (board evaluation). Board evaluations tend to focus on collective performance, leading to a report which is about the Board as a whole and is made available to the whole Board. We do not find it likely that Directors would *call out* individual colleagues for not committing enough time in a written questionnaire (typically used in internal board evaluations). In our experience providing external board evaluations, there is so much to cover in interviews that it is not the best forum to go to depth on individual contribution and commitment, and again we would feed this back to the Chair rather than put it in the report to go to the whole Board.

Instead, we suggest this forms part of the individual director feedback process, which is often overlooked or is something Boards do not make the most of. The Chair, meeting with each director one-to-one at least annually to discuss their performance, should discuss with the director their time commitment, as well as their contribution in and out of meetings and any bespoke or collective training needs. These meetings should also be an opportunity for the individual to give feedback on what more the Chair can do to help the individual to contribute more effectively, and to raise any concerns about the performance and commitment of other Directors. There could possibly be a stronger role for the SID in agreeing individual director feedback messages with the Chair to mitigate that some Chairs are not so good or comfortable giving feedback.

Principle K masks the breadth of a good performance evaluation by focusing on composition (referencing both composition and diversity) and dynamics, but not referencing words like effectiveness and efficiency that pertain to things like decision-making, management support, Board and Committee governance, setting strategy, oversight of performance, people, risk, operations... The *Guidance on Board Effectiveness* captures this breadth better, but the Principle could be more clear that an evaluation/performance review is about overall effectiveness.

**Q5: Do you agree with the proposed change to Code Provision 15, which is designed to encourage greater transparency on directors' commitments to other organisations?**

This seems a reasonable addition to provoke discussion and encourage Boards to keep this under review. In terms of plural NEDs, we tend to find the attitude of the individual is a better determinant of their commitment than how many Boards they are on (except a few cases where they are clearly overstretched, especially where someone is Chair of several Boards). NEDs who serve as Executives elsewhere are more likely to have issues committing the time, especially when the business is under stress in their Executive role – Boards place a lot of value in having serving Executives among their NED cohort, so often this is a case of *taking the rough with the smooth*, accepting they will have periods of capacity constraints, and perhaps mitigating by ensuring they do not chair a Committee.

**Q6: Do you consider that the proposals outlined effectively strengthen and support existing regulations in this area, without introducing duplication?**

We completely support that Boards should be diverse, including in terms of gender and ethnicity – in our experience, generally, Boards with a better gender balance are more rounded and effective in a number of ways. However, a consequence of targets which have been set is that Shareholders are often voting against the Chair where they do not hit the targets, which is leading to Boards feeling obliged to hit the target no matter what. As such, we often see Boards setting out to appoint *a woman*, for example. While this is done tacitly, it is illegal to appoint someone over a more suitable candidate based on protected characteristics, even if it is *positive discrimination*. Boards can try to get around this by broadening job specifications to be able to argue that candidates are at least equally suitable, but the fact is they are ruling out candidates from the start based on their gender.

We are going to see a lot of male SIDs replaced by women in the coming years (as the easiest way to hit the FTSE Women Leaders target that at least one of the Chair, SID, CEO and CFO should be female). While this is correcting historic wrongs, is it legal to remove someone from their role based on gender?

**Q7: Do you support the changes to Principle I moving away from a list of diversity characteristics to the proposed approach which aims to capture wider characteristics of diversity?**

When conducting Board evaluations, a common *excuse* we hear from Boards is that they do not have much gender/ethnic diversity but have cognitive diversity instead. We feel it is particularly important that Boards realise they need to do both.

Where it reads: *They should promote equal opportunity, and diversity and inclusion of protected characteristics and non-protected characteristics including cognitive and personal strengths.*

We would prefer, just to be clear both need focus *...diversity and inclusion of protected characteristics, and also of non-protected characteristics...*

Principle I also references *an effective succession plan* for the Board and Senior Management. This can lead to the interpretation that NEDs and Management should be captured together, which does not work very well. We suggest *effective succession plans* – for NEDs, this means understanding length of tenure and the overall mix of skills needed for the future, where for Senior Management it might look at individuals who could fill the role in a given timeframe, setting out how they will be developed to accelerate their readiness.

**Q8: Do you support the changes to Provision 24 and do they offer a transparent approach to reporting on succession planning and senior appointments?**

Yes – a lot of Boards are not doing enough around Senior Management succession, or their approaches are rather ineffective. Nomination Committees are under-utilised to support and scrutinise this. There could also be much closer oversight of Senior Management appointments – we would not expect the Committee to lead the process in the way it does for a NED appointment, but they tend not to be close enough to understanding the process or the shaping of the senior team.

The point that already existed under Provision 24 about board evaluations potentially duplicates – most Annual Reports set this out along with the rest of the information on the board evaluation. Nomination Committees could play a stronger role in agreeing the approach for the upcoming review and overseeing that agreed actions are implemented – perhaps that is what should be reported by the Committee (with the actual outcomes and actions still captured in the section on the board evaluation).

**Q9: Do you support the proposed adoption of the CGI recommendations as set out above, and are there particular areas you would like to see covered in guidance in addition to those set out by CGI?**

We believe the term *Board Performance Review* is different but not better (from memory, whether or not to adopt this specific term was an outcome of the CGI review rather than a question). Our concern is that it appears to narrow the scope, confining it to how well the Directors perform, and possibly putting the spotlight on individuals rather than looking at the wider context in which the Board sits. The term *effectiveness*, for example, feels much more rounded, encompassing how the Board works, how it is supported by Management and how it fits within organisational governance – it also alludes to outcomes and whether the Board is successful in what it is trying to achieve. To give a crude example to make the point, one could say a Board has *performed* well under the circumstances, bringing strong skills, robust challenge and committing time, despite being provided inaccurate information by an opaque Management team which renders the Board *ineffective*. The term *Board Effectiveness Review*, is already commonly used synonymously with *Board Evaluation*, so we are not clear why it was not chosen instead.

Regarding the guidance, we liked the idea that evaluators would be expected to agree that the disclosure reflects the process and outcomes of the review. Our experience, reviewing annual reports, is that they could be more explicit about the process, specifically capturing who was interviewed (for example, all Directors, the Company Secretary, five Executive Committee Members and the External Audit Partner), naming the meetings that were observed (for example, the Board, Audit Committee and Remuneration Committee), and giving more sense of the thoroughness of the document review (it is often not clear whether the reviewer merely received the papers for the meetings they observed, or whether they spent time reviewing papers, the terms of reference/matters reserved, skills matrix, forward agendas, etc.).

**Q22: Do the proposed revisions strengthen the links between remuneration policy and corporate performance?**

The bit that we find a lot of Remuneration Committees to be missing is that to be effective in setting Senior Management pay and bonuses, they need to have sight of their objectives at the start of the year and their performance outcomes at the end on an individual basis. Not all are doing this beyond the Executive Directors, even if they formally agree the amounts.

**Additional comments:**

**Provision 2** now reads: *The board should assess and monitor culture and report on how effectively the desired culture has been embedded.* Is this explicit enough that the Board should report on *how* it assesses and monitors culture (generally we feel this is something Boards do not do nearly as well as they could, regardless of what they say in their Annual Report, although we are seeing examples of more sophisticated approaches in financial services).

**Provision 5:** *Or* is duplicated in the second and third bullets (perhaps it should not be there at all as the provision says a combination is allowed).

**Provision 11:** *At least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent.* This effectively permits a Board that has *explained* having a Chair who was not independent on appointment to not have an independent majority. It should say *more than half of the Board should be non-executive directors whom the board considers to be independent, inclusive of the chair if they were considered independent on appointment.* Where a Chair is non-independent, it is all the more important that the majority of the Board is independent.

**Provision 12:** Describes the SID as a *sounding board* for the Chair. We often also describe them as a counterbalance to the Chair and suggest they should be (and be perceived to be) suitably independent of mindset from the Chair.

**Provision 33:** It reads: *The board should establish a remuneration committee of independent non-executive directors with a minimum membership of three, or in the case of smaller companies, two. In addition, the chair of the board can only be a member if they were independent on appointment and cannot chair the committee. Before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for at least 12 months.*

We suggest removing the ambiguity about whether an independent chair of the board is included in the minimum membership of three or whether they would have to be a fourth member – looking at Terms of Reference, companies do interpret this differently. We favour the flexibility that they could count as one of the three – a Board of only five NEDs, say, might have three on the Audit Committee (which would not include the Chair) and three on the Remuneration Committee (including the Chair).

Further, while it might not be desirable to state it in the Code, regarding the Committee Chair having at least 12 months experience it can make a difference if that is with a) a different company, not just serving on this Committee for a year before being promoted, and b) a FTSE-listed company, where experience on a non-listed company might not prepare them for the role. That said, we have also seen NEDs who serve as HR Directors elsewhere waiting a year to step up to Committee Chair to meet the rules, even though they are clearly the most suitable person for the role and already have the skills and experience.