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CEO Roundtable
Lessons from the Top

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On November 17 and 18, 2011, IMD hosted its annual flagship CEO Roundtable, attended by more than 70 of the world's most influential industry leaders, CEOs and chairmen. They discovered the latest research on corporate governance from the IMD Global Board Center and exchanged candid opinions about how to make boards more effective in the future.

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The research trends on corporate governance and boards suggest that the board today must be active and engaged to be relevant in the changing, global world. This contrasts with the historic, agency theory-based view which is disconnected from practice; it portrays CEOs as "bad guys" who act out of self-interest and must thus be monitored and controlled.

The CEO Roundtable, directed by Professor Didier Cossin of the IMD Global Board Center, raised some interesting questions and offered potential solutions. It brought together the research and experience of IMD faculty with perspectives from regulators, board members and CEOs in both public and closely held organizations. Three sessions looked at how to make boards more effective, lessons from transitional economies and learning from closely held organizations.

Roundtable 1: Making boards useful

Guest speakers Andrew Gould, Chairman of Schlumberger, and Gerard Kleisterlee, Chairman of Vodafone, shared their insights and experiences as CEOs and board members. Professors Paul Strebel and Phil Rosenzweig added their personal and research perspectives on making boards effective.

This roundtable exposed the difficulty that board members face in challenging proposed strategies, an obstacle that is only exacerbated when the CEO has a dominant personality. Mr Gould illustrated this struggle with a personal example. In 2002, the board of Schlumberger, a worldwide provider of oil and gas services, approved a diversification strategy proposed by its then CEO. The company expanded into IT services by acquiring Sema for $5.2 billion, of which $2.8 billion was for goodwill. The markets reacted poorly, eventually leading to financial losses and a decrease in employee morale. Mr Gould was appointed CEO in early 2003 with the mandate to refocus the company on its core capabilities. Thus, in the space of only 18 months, the Schlumberger board had approved the acquisition of Sema and its subsequent sale – at a substantial loss. Reflecting on what had led to this situation, the Schlumberger board realized there were four main factors. First, the former CEO, who had led the company for 15 years, was determined to make this acquisition and threatened to resign if thwarted. In addition, the board members did not know the business context well enough to contest his strategy. Furthermore, it was unaware of concerns that both investors and employees had raised about the strategy. Finally, it had little exposure to executives other than the CEO – he had not allowed the board access to other leaders on the top management team (TMT).

Mr Kleisterlee, whose perspective on boards was formed by his experience as CEO of Royal Philips and as a board member in other companies, agreed that it is difficult for board members to disagree with CEOs. He also noted that it can be hard for boards to add *substantial* value: CEOs and TMTs know so much more about their industry and its context. During his tenure as Philips's CEO, he had had a supportive board but realized that meeting six times a year was not enough for its members to be able to ask probing and revealing questions. He acknowledged that he had believed that in order to maintain a good relationship with the board, it was enough for the CEO to be on good terms with the chairman, while the CFO fostered a positive rapport with the head of the audit committee. Upon reflection, Mr Kleisterlee realized that he had perhaps contributed to keeping the board distant because he had not actively sought members' opinions on matters to which they could have contributed.

Professor Strebel focused on how boards could increase the degree to which they are in touch with their stakeholders. He noted that in good times, boards are seen as advisors, while in bad times they are dismissed as out of touch. He believes that *how* companies select board members is an essential element – more diversity and independence on the nominating committee are needed to bridge with the outside world. The current self-perpetuating, "cloning" way of selecting board directors encourages members to empathize with the CEO and chairman. In the words of Nell Minow, once dubbed the "queen of good corporate governance" by *BusinessWeek* and named one of the 20 most influential people in corporate governance by *Directorship* magazine in 2007, "The only thing that matters is who gets to choose who sits on the board."

What matters is who is on the board and how well it works. There is a move toward board reviews, conducted by outsiders every three years, to see how the board functions.

John Grumbar, Honorary Chairman, Egon Zehnder International

To add value and prevent a future corporate disaster, boards should venture beyond the boardroom to identify which stakeholders are critical for future value creation, adapt the board composition to facilitate reaching out to these value critical stakeholders, develop communication channels with them and tune into what they are saying to promote the creation of long-term value.[2]

The lessons from this session can help boards increase their usefulness and remain relevant in changing environments. Boards can add value by focusing on a few critical areas that are essential to the company's success: ensuring the board is independent; understanding the business context; and preparing for crises.

The Halo Effect

Describing the halo effect, the subject of his eponymous book,[1] Professor Rosenzweig noted that it looks at the delusions and errors that besiege managers. People tend to use *general* impressions of a person or organization to make *specific* judgments about them. When a company is performing well, everyone gushes about how fantastic the leadership team is and how brilliant their strategy. Then, when times turn bad, the same people change their opinion, insisting the strategy was terrible and the leaders incompetent. Companies gather a lot of data that are influenced by the halo effect. They need to remember that it is the *quality* of the data that matters, not the quantity.

Fostering an active, engaged independent board

A board that merely rubberstamps the CEO's strategy does not add value. Fostering an independent board in which members can openly share their concerns is critical, and one way to do this is to separate the positions of Chair and CEO. Another strategy the board can use is to organize regular meetings and activities, both formal and informal, without the TMT; some could even take place offsite. The board should not depend on the CEO for its information and access to others in the organization. It should regularly meet with other members of the TMT and executives to have a wider view of what is happening. Finally, it should think about its composition. Questions to ponder include: Is there a balance between new and old members? Are there members from different, but relevant, industries? What is the age distribution?

Understanding the business context

Board members need to understand the industry in which the organization operates in order to be able to approve or reject proposed strategies. This is especially important with dominant CEOs. By going offsite with the TMT, the board can discuss alternative strategies with them and learn about the different operations and broaden members' industry and company knowledge. Together, the board and TMT

[1] Rosenzweig, Philip M. 2007. The Halo Effect: And the Eight Other Business Delusions that Deceive Managers. New York: Free Press.

[2] Strebel, Paul 2011. In Touch Boards: Reaching Out to the Value Critical Stakeholders. 10th European Corporate Governance Conference, Brussels. Corporate Governance, Vol. 11, No. 5, pp, 603-610, 2011.

should agree which stakeholders can make or break the company's strategy – regulators, major shareholders, large customers, employees, NGOs – and understand their concerns. In addition to measures taken together with the TMT, the board should also institute an onboarding process for new members so they understand the business, stakeholders and context as quickly as possible.

Preparing for crises

Regular meetings with key executives in the organization help give the board a broad perspective on what is happening in the company. Having good working relationships already established within the board is particularly essential during a crisis, so board members need to interact regularly, and not only formally. The offsite meetings and visits to operations that promote the board's understanding of the business can also facilitate an environment in which members can react if needed. Finally, the board should always have an idea about who could replace the CEO if necessary.

Roundtable 2: Another way – governance in transition economies

Guest speakers Tan Sri Datuk Zarinah Anwar, Chairman of the Malaysian Securities Commission, and Oba Otudeko, Chairman of Honeywell Group Ltd, discussed their experiences and insights as regulators and board members in transition economies. Professor Nuno Fernandes discussed his research on executive compensation around the world.

Both Ms Anwar and Mr Otudeko noted that corporate governance in emerging markets presents challenges not found in developed ones because often the government or a single family has a controlling interest in companies. These shareholders nominate board members, who may be neither truly independent nor even qualified. This prompts many questions: How are minority shareholders' interests protected? Who regulates the regulators? What does it mean to be an independent board member in countries in which business and politics are tightly interconnected? And, how can Western companies adapt to doing business in this environment?

Ms Anwar observed that in emerging markets a culture of good corporate governance is driven by governments and regulators rather than by markets. She believes a certain amount of regulation is important for shaping and influencing behaviors, so that ultimately self-discipline and market discipline can prevail. Her goal is to move beyond compliance and embed good corporate governance in Malaysian business culture. Both Ms Anwar and Mr Otudeko agreed that independent board members are needed to provide objectivity but are difficult to find in emerging markets due to a small talent pool. They suggested measuring board effectiveness to help the board add shareholder value.

Ms Anwar shared some innovative steps that Malaysia has taken, or is currently considering, to improve corporate governance:

- Separating Chair and CEO.
- Mandating an independent Chair.
- Assessing directors' performance to help companies dismiss non-performing directors.
- Capping independent directors' tenure at nine years.
- Establishing a goal (not a quota) of 30% women board members within five years.
- Sponsoring an organization to create a Directors' Registry, thereby creating a pool of competent, talented managers and matching them with companies that need independent directors.
- Introducing a corporate governance self-assessment and development tool.

Professor Nuno Fernandes' research shows how difficult it is for regulators to influence organizations. When regulators implemented new rules on executive compensation, instead of compensation decreasing, it increased. Furthermore, he noted that comparing compensation levels from the US and EU is like comparing apples to oranges. Executive compensation in the US was $5.5 million

Sometimes applying regulation over different geographies globally can have the law of unintended consequences.

Penelope Warne, Partner CMS Cameron McKenna

compared to the EU median of $2.5 million, a 170% premium. However, once differences between US and EU firms – ownership structure, size, industry, leverage, volatility, CEO characteristics – were accounted for, US CEO compensation was in line with EU pay.

Roundtable 3: The closely held corporation – governance winner?

Guest speakers Alfred Gantner, Executive Chairman of Partners Group, and Marcelo Odebrecht, President & CEO of Construtora Norberto Odebrecht SA discussed what public companies could learn from the private equity and family business perspectives.

From 1993 to 2010, private equity (PE) companies outperformed public companies on many levels: Employment growth, EBITDA compound annual growth, and EBITDA per employee were all more than 50% higher. Mr Gantner attributed this performance to PE incentives – their CEOs earned less than half the salary of public CEOs, but received more than twice in equity ownership – which encourage a long-term growth perspective. Thus, public company CEOs and TMTs should have more “skin in the game.” Board members should also be locked into their shares and thus prevented from selling during financial bad times.

The future should be the focus for the board; they should be provocative to help the CEO and management. The out-of-the-box element should be a key component of the board’s mandate.

Harry van Dorenmalen, Chairman IBM Europe

Mr Gantner noted that non-executive board members of public companies tend to focus on risk avoidance rather than value creation, whereas PE boards excel at strategic leadership, performance management and stakeholder management, public company boards tend to focus on governance, compliance and risk management. Furthermore, public company board members do not share the financial upside if the firm is successful but lose their reputation in case of failure. Given these differences, a public company board is more likely to accept the CEO’s big, strategic deals rather than focusing on organic growth. Public company board members are not sufficiently representative of the firm’s owners; in fact they are simply performing a job and tend to sympathize with the TMT rather than with other stakeholders.

Mr Odebrecht described his company as a confederation of 300 companies. He discussed the complicated structure of this family business, which includes 100% family held companies, joint ventures and public companies. It selects partners that think in the long term and controls all of the businesses, except the JVs, to ensure that all the companies have the same culture. Therefore, it is easier to move people around the various companies. The holding is controlled by the family; the board has only one family representative – the chairman, which is a lifetime appointment; and executive directors have a share in the holding that they must sell when they leave. Companies that are controlled by Odebrecht do not have boards; their CEOs report directly to the president of the holding. Furthermore, in order to avoid conflict in both the family and organization, the president only meets with his father, the Chairman, once a year. Mr Odebrecht offered these guidelines for making an effective board from the family business perspective:

- Ensure governance starts with the family and that issues are settled before meetings
- Think about all stakeholders, not just shareholders, when making decisions.

Conclusion

Organizations face a complex and changing world, which an effective board can help them navigate. To become more effective, a board should promote diversity of perspective and the independence of directors, who nevertheless should have a good understanding of the company’s business context. In the wake of globalization, corporate governance is becoming more of an issue in transitioning economies, where regulation is on the increase. Public company boards could also learn from closely held companies to foster innovation and long-term thinking.