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# Integrity should be on the table in the boardroom *- the role of culture and behaviour in corporate governance codes*[i]

Dear all

Thank you for having me here to address the importance of culture, integrity and behaviour as an essential feature of good corporate governance, and thus should be included in corporate governance codes.

After the corporate scandals in the 90s of Enron, WorldCom, Ahold and others, corporate governance codes were drafted and implemented in national laws and regulations. Unfortunately, these corporate governance codes did not result in a society where companies, directors and their relevant stakeholders lived happily ever after. On the contrary, due to an ongoing supply of new financial scandals and societal deceptions, also with integrity issues, our society increasingly distrusts executive and non-executive directors, as they often appeared to play a significant role in these scandals. Directors are often accused of having overlooked the important issues or having failed to intervene in company decision-making.

Also in the UK a Corporate Governance Code was introduced in 1992. According to the Financial Reporting Council it especially ‘placed great importance on clarity of roles and responsibilities, and on accountability and transparency. However in 2011 the FRC stated that “it has become increasingly clear in the intervening period that, while these are necessary for good governance, they are not sufficient on their own. Boards need to think deeply about the way in which they carry out their role and the behaviours that they display, not just about the structures and processes that they put in place.”

Indeed corporate governance codes emphasized on structures and processes, and less on behaviour. Already in 2009, I published a Code of Conduct for Non-executive directors. At that time this initiative came to soon, directors weren’t ready yet to look into their own behaviour and argued that they all know what good behaviour and moral standards mean, and no code could change that.

Besides society's growing disapproval of the role of directors in our society, our motivation to formulate a code of conduct came from the results of the annual Dutch Non-Executive Directors Survey in 2008. This survey showed that directors often act on the basis of unwritten rules and, for example, do not know the consequences of poor functioning or what independence actually means. The 420 directors in the survey have different opinions, which in itself is not undesirable, but what if the unwritten rules of one director differs from those of another supervisor in the same Board. What 'truth' will in that case prevail?

The fact that directors themselves are not always sure what exactly their role and tasks are, or how their performance should be evaluated, is not surprising when one considers the vast amount of research on the (discussed) role of directors or the many differences in the internationally applicable governance codes and models.
First, scholars in (corporate) governance research have different views on the role of directors with respect to their task of supervising the management of the organization. For example, agency theory, stewardship theory and resource dependency theory have different opinions on the role and tasks of directors. According to agency theory, directors are independent supervisors who should serve shareholder interests by restraining management from pursuing their own interests. On the other hand, proponents of the stewardship theory argue that directors will have more added value in a supportive, service role and that management can be trusted. Resource dependency theory regards corporate boards as an essential link between the company and its environment and the external resources on which a company depends. From the perspective of resource dependence theory, the board of directors is a primary linkage mechanism for connecting a firm with external resources and linkage has, among other purposes, a value in legitimizing organizations. Pfeffer and Salancik explain providing legitimacy as follows: ‘Prestigious or legitimate persons or organizations represented on the organization board provide confirmation to the rest of the world of the values and worth of the organization’. Legitimacy and conformity to societal expectations are considered key components of organizational survival.

There is very little legislation in the Dutch Civil Code concerning directors. Although it describes the tasks of the Supervisory Board as monitoring and advice, it gives no further explanation of how these tasks must be fulfilled. The judiciary is increasingly using the Dutch corporate governance code(s) to fill in the vague standards of mismanagement and tort. For instance, the recommendations in the governance code are used as a means to give shape to the concepts of "basic principles of sound business practice" and "reasonable grounds to doubt the correctness of a policy". The governance code thus provides a way to determine what is meant by general principles of good corporate governance.

Do we then need an additional Code of Conduct for directors, which focus on culture, integrity and behaviour?
Schwartz argues that in order to develop and to evaluate a code of moral standards, we must first know what the universal moral standards are. On the basis of research conducted with employees and examination of business codes, general ethical codes and literature in the field of business ethics, he identified six universal moral standards.

1. *Trustworthiness*, including concepts such as honesty, integrity, reliability and loyalty;
2. *Respect*, including respect for human rights;
3. *Responsibility*, including accountability;
4. *Fairness*, including notions of process, impartiality and equity;
5. *Caring*, including prevention of unnecessary suffering and injury;
6. *Citizenship*, including concepts such as obeying the law and protecting the environment and society.

He then argues that a code of conduct should be constructed on the basis of these six moral standards, but should also indicate or satisfy

i) who the stakeholders are,
ii) that all provisions of the code are in line with these six standards,
iii) that a ranking is applied (these moral standards rank higher than maximizing profits or self- interest),
iv) that the rationale behind the provisions is made clear (even if they seem self-evident),
v) that procedural rules (consequences of non-compliance) are formulated, and
vi) that the code is written in understandable language.

On that basis we introduced ten themes in our Code of Conduct in 2009. We wrote down general principles, being:

1. Tasks and Roles
2. Independence
3. Integrity
4. Confidentiality
5. Board composition
6. Evaluation
7. Remuneration
8. Knowledge and experience
9. Responsibility
10. Accountability

Although one could argue that these are indeed normal and general accepted principles you don't have to write down, we believe that a code of conduct could at least provide guidance to directors on three key issues.

First, a code of conduct would compel the board to reflect on its own values. This is essential for the entire organization because the board is seen by society and stakeholders as a representative of the organization, and as such provides legitimacy to the values of the organization.
Second, it would compel directors to verbalize their unwritten rules. An annual evaluation of their performance, preferably with an external facilitator, on the basis of the ten themes would reveal any misunderstanding between the unwritten rules of one director in relation to that of another.
Third, it could assist in breaking 'groupthink' and group behaviour, one danger of which is the aim for unanimity in decision-making.

Unfortunately, although we had interesting debates and conferences in 2009, our code of conduct was not adapted broadly at that time.

Therefor I was very happy that in 2011 the FRC introduced their Guidance on Board Effectiveness. The FRC stated that boards need to think deeply about the way in which they carry out their role and the behaviours that they display, not just about the structures and processes that they put in place. The FRC argues that, "the new guidance is not intended to be prescriptive. It does not set out "the right way" to apply the Code. Rather it is intended to stimulate boards' thinking on how they can carry out their role most effectively. Ultimately it is for individual boards to decide on the governance arrangements most appropriate to their circumstances, and interpret the Code and guidance accordingly. "

The Guidance is composed by many principles of which we again might say that there's no need to write them down. For example, the principle that "Good boards are created by good chairmen" explained by "while the chairman creates the conditions for overall board and individual director effectiveness." However, again by explicitly mentioning what is required of a chairman, we could address such a theme in board evaluations. The Guidance for example requires from the chairman that he "demonstrate the highest standards of integrity and probity, and set clear expectations concerning the company's culture, values and behaviours, and the style and tone of board discussions."

Also, according to the guidance, non-executive directors "have a responsibility to uphold high standards of integrity and probity. They should support the chairman and executive directors in instilling the appropriate culture, values and behaviours in the boardroom and beyond."

Furthermore, "boards should be aware of factors which can limit effective decision making, such as: failure to recognise the value implications of running the business on the basis of self- interest and other poor ethical standards"

I promoted the guidance on several occasions in The Netherland and even translated the guidance in 2012 in order to make it applicable for the Dutch two-tier system. But only until now, the Monitoring Committee Corporate Governance, responsible for the revision of the Dutch Code, introduces a proposal to include a chapter on culture in the Dutch Code.

More than before with the revision of the Code the Committee focus on long-term value creation. And in the Committee's opinion, "culture plays an important role in the enterprise's functioning and the degree to which it contributes to creating long-term value for the company and its affiliated enterprise."

However, it surprises me that the chapter on culture is predominantly about the culture within the company, and of course to some extent it includes tone at the top. However, it only refers limited to behaviour of the board itself, or how directors interact with each other.

Let me first shortly summarize what <u>is</u> included.
The committee does refer to misconduct. They introduce the principle as follows: "Signs and suspicions of misconduct may be indicative of the culture prevailing <u>at the company</u>. [These signs] indicate where things might be going wrong and where a lack of clarity exists as regards the standards and values applicable at the enterprise. The absence of such signs may give an unwarranted feeling of assurance. It is important in that respect for people to know how they can expose misconduct and to feel sufficiently comfortable to do so."
"The Committee sees a role for the management board to inform the chairman of the supervisory board without delay of any signs and suspicions of misconduct or actual misconduct. "

The principle furthermore addresses five key points, being:

1. The management board and the supervisory board should promote a culture of openness and approachability <u>within the company</u> and show that they expect the same of others in the enterprise affiliated with the company. Management and supervisory board should take measures to facilitate debate among management and supervisory board members and to encourage a mutual dialogue.

2. The management board should inform the chairman of the supervisory board on signs and actual or suspected material misconduct.
3. The management board should be responsible for embedding the culture in the enterprise, including adopting common values for the company, establishing a code of conduct and endeavour to ensure that all employees and other stakeholders of the company support this code, propagating the culture by setting the right 'tone at the top' and displaying model behaviour, assuring itself of the effect of the measures taken to embed the culture; and drawing up a scheme for reporting actual or suspected misconduct within the company and post this scheme on the website.
4. If the company has established an employee participation body, the conduct and culture should also be discussed in the consultations between the management board and such employee participation body.
5. Finally in the management report, the management board should explain the manner in which a culture is shaped within the company that is aimed at long-term value creation.

There are limited principles addressed to behaviour, culture or integrity in the boardroom itself, although they are encouraged to facilitate an open dialogue between management and supervision, they are especially addressed in such a way that they supervise management board on their task to promote an open culture in the company.

To my opinion, this is a missed opportunity. The committee should have addressed more explicitly boardroom behaviour as well. This cannot be captured by tone at the top, while this is visible behaviour from the top. What I mean is the culture, integrity and behaviour we don't see. That what is happening in the black box of the boardroom, but which is essential in good governance. The UK Guidance of Board Effectiveness was able to capture this kind of behaviour as well, even though one could argue that these are open doors.

I understand, and even support, the goal to have a short and efficient governance code. However, boardroom behaviour needs additional and explicit attention, and therefor my proposal would be to have a more comprehensive Guidance of Board Effectiveness attached to the Dutch Code as well.

Thank you.

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[i] Speech derived from Lückerath-Rovers, M., & Bos, A. de. (2011). Code of conduct for non-executive directors and supervisors. Journal of Business Ethics, 100(3), 465-481;
see for English translation of revised Dutch Corporate Governance Code
http://commissiecorporategovernance.nl/?page=2840