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The social dependence of independent directors in Europe's largest companies *

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Abstract

This paper builds on SONEAN`s latest comments on the draft "Revised Principles of Corporate Governance" by the OECD (for detailed insights see http://www.oecd.org/daf/ca/SONEAN2015CGP.pdf). As every actor within the corporate world is part of a social network, that potentially limits or enhances his/her abilities, SONEAN focuses on prior and existing ties of corporate executive and non-executive directors to better understand the drivers behind their actions and spot risks and opportunities in a profound new way. We thus go beyond traditional financial and ESG (environmental, social and governance) factors and provide a complementary social network analytic perspective to create greater transparency. This also helps to better spot conflicts of interest, discipline market participants and promote accountability. Greater transparency ultimately leads to less undesirable outcomes.

Based on our two year review of the largest listed 50 European companies (by market capitalization, STOXX 50), and their 445 executive as well as 476 non-executive directors (as of 1 January 2015) who represent these organizations, we have gained highly relevant insights into the social ties that connect these decision makers to over 13,000 organizations. Hereby we have gone beyond their academic (who studied with whom where) and professional ties (who worked with whom previously), and followed a multiple tie approach including among others these directors` links to governments, foundations, think tanks, associations, the military, clubs, and many other organizations to uncover existing and prior ties. This paper, which just represents the tip of the iceberg when it comes to our overall findings, focuses on the role of so called "independent directors" as a subset of non-executive directors who have an important control function in corporations and are supposed to among others monitor the activities of executive managers/directors.

In the largest 50 European companies we identified 121 independent directors (out of 476 non-executive directors) and based on our data see that at least 44% have prior or existing ties (through university, past mutual jobs or other institutional ties) to their respective executive managers. From a social network perspective this leads us to the conclusion that these independent directors cannot be regarded as independent but be seen more as socially dependent. We therefore argue that existing social ties should therefore be incorporated in the definition of "independence" and transparently communicated. Thus it is not just enough to transparently share existing board memberships when directors join a new board but more importantly to declare who gave the impetus for joining the board and whether the new director has existing ties with either the executive or non-executive board members. This increased transparency will be vital to judge true independence and the objectivity of the hiring process for institutional investors (asset managers, and asset owners), i.e. shareholders in general.

The latest governance rules by the OECD should consider the importance of social ties in the corporate decision making process and their impact on governance, remuneration, hiring, and corporate decision making in general. Without social network and ties related insights investors and shareholders alike will be missing a very important perspective and it will not allow them to see the "whole" picture as the OECD rightly propagates.

In the following we will provide descriptive statistics about the executive and non-executive directors that run and monitor the largest 50 European companies and highlight the multiple issues investors face and why understanding the social networks behind organizations will be crucial going forward to strengthen corporate governance.

1) Background

In the early 21st century, both the US and the EU economy were shaken up by corporate scandals. Developments at ENRON, Parmalat and Ahold, just to name some prominent ones, combined with the global financial crisis of 2008 created certainly a crisis of trust with the corporations and the economic system and lead to action by governments in order to improve the standards of corporate governance.

The Sarbanes-Oxley Act in the US and European Commission propositions for improvement in governance both underlined the importance of independent board members in protecting the interests of shareholders and other stakeholders. Independence in this context is simply defined as "the absence of any material conflict of interest". The European Commission created recommendations for its member states, leaving the implementation to each individual country. For example, the proportion of independent board members in the board is not defined and left to the member states due to the differences in the legal systems. As a result there is a variation in terms of laws, regulations, and implementation of board practices across Europe.

At SONEAN, a social network analysis based intelligence and strategy consulting company we researched the boards of the top 50 companies in Europe (STOXX 50) in great detail. After two years, and 10,000+man hours of diligent work, we identified all of the directors in executive and non-executive boards of STOXX 50 companies and uncovered the multiple social ties, linking them to over 13,000 organizations. The findings are quite alarming. Out of the 121 board directors who were identified as "independent" by their companies, 55 or about 44% have some form of prior relationship with at least one of their respective executive board members.

When we analyzed the data in more depth, we identified multiple forms of relationships. Using the extensive literature on social network analysis, we realized at least 4 mechanisms in which the "independent board directors" are recruited into their positions. All of these mechanisms effectively undermine the independence of the board members. Before we explain our findings related to independent directors in more detail, we would like to shortly provide you with some interesting descriptive statistics.

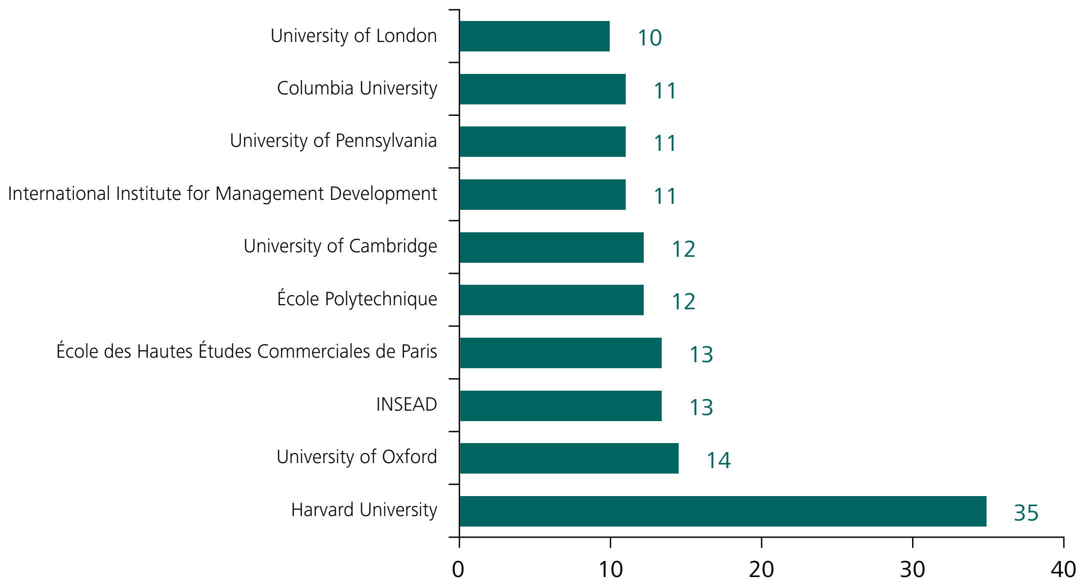
As you can see women make 13 % of existing executive board memberships (management) while they represent 24 % in the non-executive boards (21 % of the independent directors are women) in the top 50 companies by market capitalization.

2) Our sample universe

The number of executive and non-executive directors among the largest 50 European companies (STOXX 50) as of 1 January 2015

Number of Unique Executive Board (Management) Members	445	
Male	387	
Female	58	13 %
Number of Non-Executive directors	476	
Male	363	
Female	113	24 %
Number of Independent directors (part of the non-executive directors)	121	
Male	96	
Female	25	21 %

The top 10 universities and management schools that executive managers (n = 445) attended among the largest 50 European companies (STOXX 50) as of 1 January 2015



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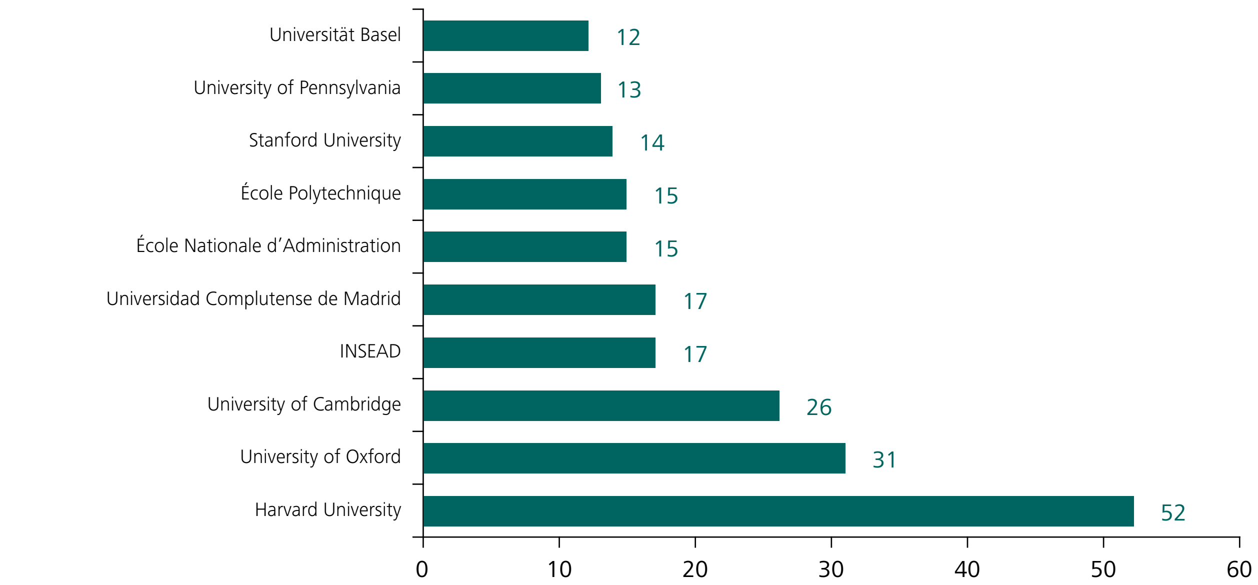
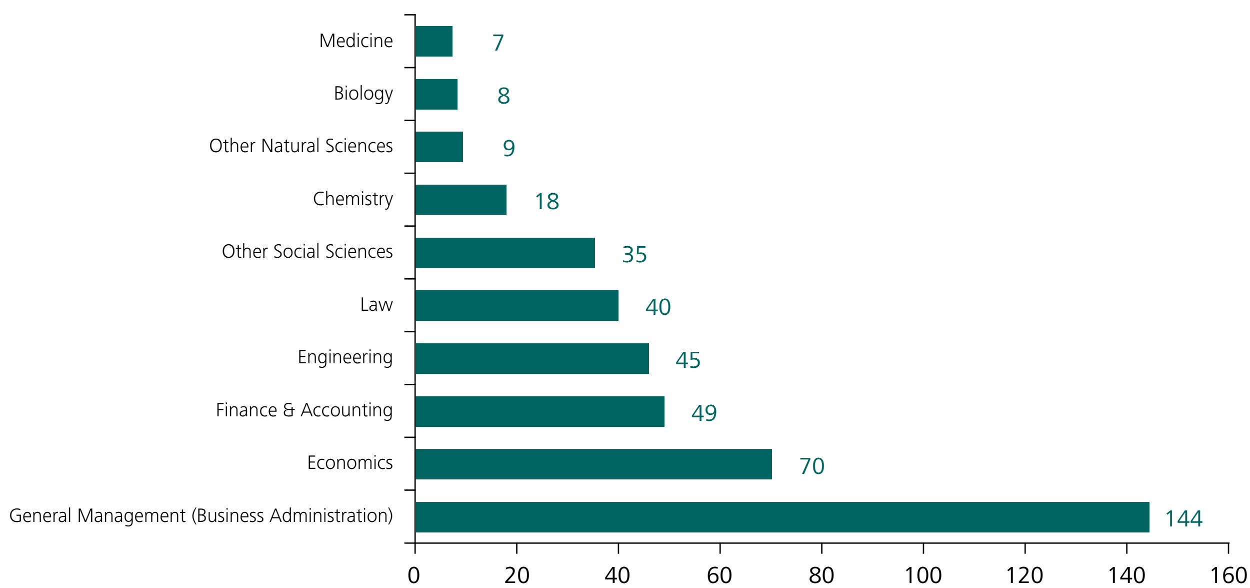
The top 10 universities and management schools that non-executive directors (n=476) attended among the largest 50 European companies (STOXX 50) as of 1 January 2015



As you can see people who attended tertiary education (including advanced management programs, MBAs etc.) mainly went to American, British, and French schools and 35 of our executive managers and 52 of non-executive directors are tied to Harvard University (including its business school) based on prior education. Universidad Complutense`s position can be very much traced back to the Spanish companies in the top 50.

The top 10 majors that executive managers (n=445) were exposed to/studied during their education (among the largest 50 European companies – STOXX 50 – as of 1 January 2015)



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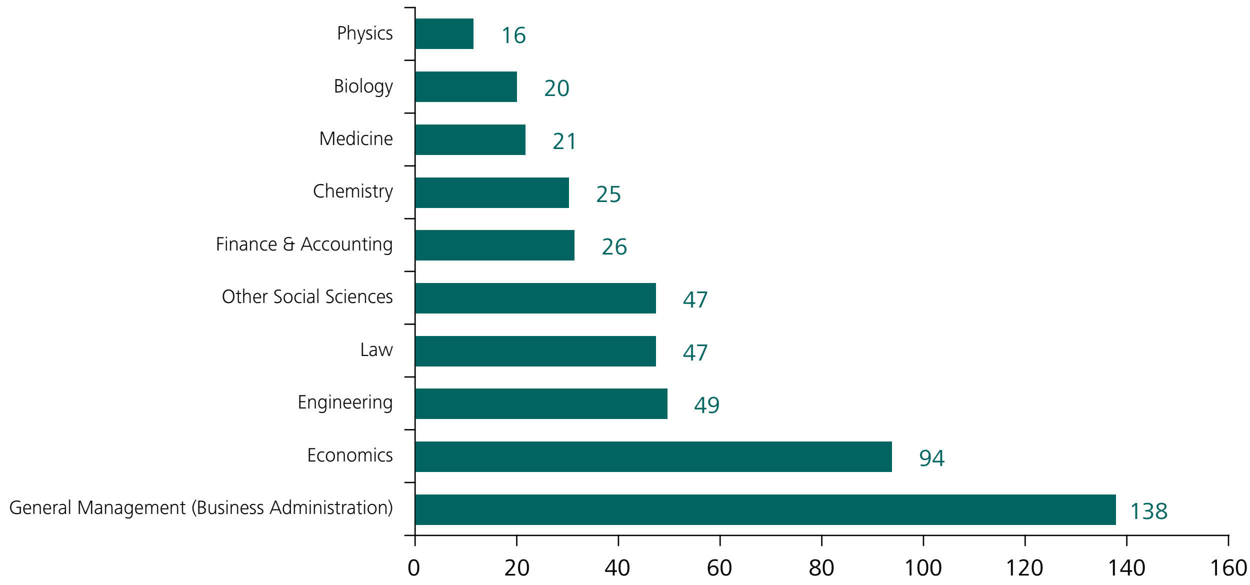
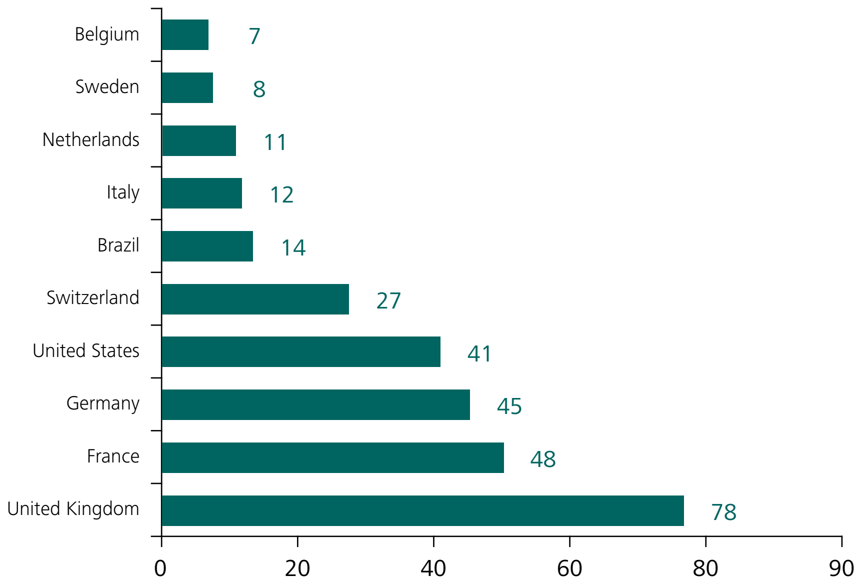
The top 10 majors that non-executive directors (n=476) were exposed to/studied during their education (among the largest 50 European companies – STOXX 50 – as of 1 January 2015)



The top 10 nationalities/countries that executive managers (n=445) represent (among the largest 50 European companies – STOXX 50 – as of 1 January 2015)



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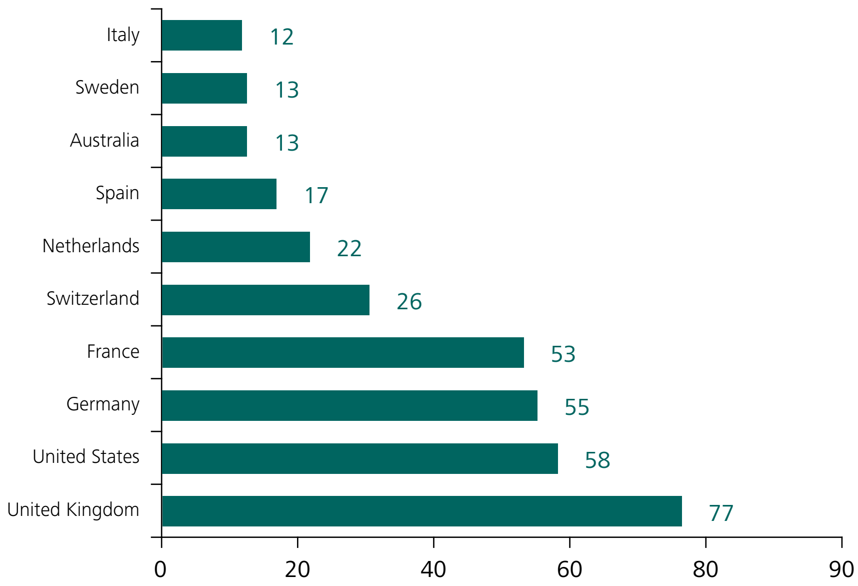
The top 10 nationalities/countries that non-executive directors (n=476) represent
(among the largest 50 European companies – STOXX 50 – as of 1 January 2015)



It is interesting to highlight that US citizens represent a large part of the executive management in European companies (no. 4) while they dominate the non-executive board (no. 2) after their peers from the UK. The picture gets even more compelling when you look at the individual sectors that certain nationalities dominate and of course the respective networks which have built up in those specific areas (such as e.g. in financial services, luxury goods, and energy).

3) Redefinition of independent directors based on their "social dependence"

As highlighted earlier we used the literature on social network analysis (and social capital) to see that at least 4 mechanisms are in place in which the "independent board directors" are recruited into their positions. All of these mechanisms effectively undermine the independence of the board members and thus have an impact on the governance of these companies. Institutional Investors (asset manager and owners alike), i.e. shareholders in general should have greater transparency about these mechanisms to better judge the impact on corporate governance and strategic decisions made by the companies in which they invest.

a) Good Old Friends

This form of relationship was observed in many organizations. The case of a large Spanish company shows e.g. that the CEO and the independent directors in the board are closely related based on prior ties. The CEO started a company together with one of the independent board members in the 1980s and they continued working together for several years until they sold the company. They also worked together in a bank for multiple years. Furthermore, there are two other managers in the executive board that also worked in the same start-up company for years. In addition, two of the other independent directors were directly supervised by the current CEO in the past while he was the CEO of another company. Finally, a fourth independent director was the successor of the CEO in the same company and worked together with the two other independent directors. One may ask "so what is wrong with having long-standing ties sitting on the board of a company?" Isn't it the goal of the executive directors to bring trusted and capable individuals into the board?

Actually, while bringing trusted people into the board (e.g. as non-executive directors in general) may help the quality of governance in specific circumstances, this is definitely not true for independent board members. By definition these members should not have a conflict of interest while performing their duties. They are placed in remuneration and audit committees which work best when their members are not related to the company and do not have social ties to the managers. In the Spanish company we mention here, in 2013, the remuneration committee consisted of 5 members in which 3 including the president of the committee were the "independent" directors we discussed above. A fourth was also socially connected to the other people in the executive board. The established research in sociology on 'reciprocity' shows us that human beings have an inert need to return a gift: not always immediately, but certainly sometime in the future. When a CEO brings old friends into a board, one cannot avoid to ask "what do they owe to the CEO and how will they pay back?" Furthermore, bringing together multiple friends and colleagues into the board extends the power and the influence of a CEO and makes it difficult for the board to control his/her behavior. The example of a major Swiss bank`s CEO hiring a new executive board member (based on prior ties) with a double digit million USD welcome bonus is certainly an outcome of such interconnectedness which should be spotted by shareholders (asset managers and owners alike) early on before it becomes a liability for the company. As non-executive directors, and specifically independent ones, have a crucial monitoring function and are supposed to represent the interests of shareholders this is even more important. Being independent from a social network perspective, i.e. not being historically tied as an independent director to executive ones, can increase the objectivity of the audit process and even have clear impact on remuneration, and all other organizational decisions.

b) Homophily, birds of a feather flock together

People who are "similar" and who have worked or studied at the same schools e.g. tend to like each other. We found that at least 25 independent board members within the universe of top 50 European companies, went to the same school or worked in the same company that links them to their executive board members. For example, in a French company, two independent board members and three executive board members were all graduates of the same school. The academic research shows that one of the fundamental ways to make new contacts is through existing ones. For example, among college students who did not share a common class having a mutual contact increased the probability of email communication by 140 times! (Kossinets and Watts, 2006). These findings have been replicated in churches, coffeehouses, factories, and among scientists (Hammer, 1990; Newman, 2001). So, this is a naturally occurring phenomenon, nevertheless it might be potentially harmful in boards. When an independent director is part of a clique that is driven by homophily, his/her independence will be compromised. Homophily then leads to less heterogeneity/diversity which ultimately affects innovation, and consequently performance. In such cliques norms for conformity are created and enforced more effectively and thus voicing dissent is difficult. As a result of these factors making independent decisions become extremely difficult. This situation is even more troublesome when members of a clique act as an organized minority and dictate their agenda within the board. Independent board members are particularly thought to be a defense mechanism against the activities of these groups. When they are in fact part of these groups, their ability and their motivation to defend the rights of shareholders will be minimal.

c) Revolving door

In almost all major countries of Europe, there are examples of the "revolving door" phenomenon. For example, in a highly publicized incident, one top regulator from the US who in the past had strongly argued against the practice of regulators taking jobs in private sector, moved to a Spanish company as an independent director! Similarly, a right-hand of an ex British prime minister took a job in a British company. These ex-regulators can be seen as effective independent board members because of their experience in regulation. However, the flip side of the argument is that as this becomes a common behavior in an industry, it causes the regulators to act more liberally and also to develop relationships with businesses during their tenure in government because of an expectation of a future job with higher benefits. There is a serious conflict of interest inherent in the behavior that would be carried over to their role as an independent board member.

d) Sharing current memberships in other boards

Several independent board members sit on the board of other companies together with the executive board members. This complicates the relationship between the executive board and the independent director since the relationship is embedded in multiple ties. For example, decisions in two boards can become part of a negotiation or bargain: independent board member can be asked to vote in a certain way in exchange for the vote of the executive board member to go his or her way in the other board.

Summary

The four mechanisms we highlighted and the numerous examples are certainly at play in our universe of 121 independent directors of whom at least 44 % are tied socially to the executive management. We say at least as despite the two years of detailed, multiple source, research with a sizeable team of researchers and analysts we might not have accounted

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for all ties. Our point however is clear: The whole picture about an organization as suggested by the OECD cannot be formed without the consideration of social ties between executive and non-executive directors and their connections to organizations outside the company. In order to discern the "whole picture" it is essential to go beyond the current recommendations and include social network related aspects, as a relevant jigsaw in the puzzle would otherwise be missing.

Understanding in which social networks people are embedded will help in getting closer "to the whole picture" and complement existing information. Shareholders and stakeholders thus should not look at companies in isolation but from a connected perspective which allows them to understand in which networks the actors are embedded and how it can potentially affect governance, strategic organizational decisions as well as ultimately the performance of the company. It should be clear that social network (ties) related transparency will help decision makers to better judge financial and non-financial factors but more importantly look at the organization from an embedded perspective. Creating transparency around those ties and pro-actively asking new board members to declare existing ties to executive and non-executive board members will be of crucial assistance.

We hope that our research can contribute to greater transparency and thus lead to the integration of social network related data into the decision making process. We are convinced that in the years to come social network related insights will form a fundamental pillar of analysis next to financial and non-financial (such as environmental, social, and governance, i.e. ESG data). Considering social ties in corporate governance will help to bring about more objective decisions, and create greater diversity. This has even strong implications on the current discussion about women in boards as women without prior links to existing board members, who objectively seen might be more suitable and add greater network diversity, have difficulties to join boards due to their lack of ties. Many of the women joining today are historically connected to other board members through prior academic or professional ties and thus enjoy a clear relative advantage in the selection process.

About SONEAN

As a SNA (social network analysis) based strategy consultant and intelligence provider, we bring the complementary social network perspective into our clients` investment (decision making) process and move them beyond financial and non-financial data to help identify risks and opportunities in a unique way. Our work mainly focuses on the entrepreneurial ecosystem (startup community) as well listed European companies space and provides investors (asset managers and asset owners alike) a new and crucial dimension when it comes to their investments. In our startup ecosystem research we currently include over 5000 German/European startups in our daily monitoring and their ties to over 1000 relevant investors from across the world, a database that is expanding every day. Here our analytics allow us to provide unique inputs for the entire investment approach from sourcing or screening startup investments, to the due diligence and portfolio monitoring process but also the exit phase. We complement our clients` investment activities by providing an unparalleled transparency into the startup community/entrepreneurial ecosystem, including central actors and institutions, giving unique insights into how investors and startup founders are historically tied to each other through their social capital and the risks and opportunities that emerge from those links. We also go deeply into the co-investment clusters using respective algorithms as investors typically tend to stick to specific co-investors in their investments, limiting, without being aware of, their sourcing capability and return potential. Our insights into the German/European startup community allow asset managers and asset owners alike to better control their investments and generate more optimal returns by providing them independent and objective intelligence and advice about specific portfolios managed for them or even regarding the startups that form their direct investments. A semi-automated and optimized portfolio monitoring service coined by us as "Ecosystem Intelligence – The Future of Portfolio Monitoring" (based on multiple years of data), run by a dedicated team, screens ongoing developments in the entrepreneurial ecosystem and unlisted companies on a daily basis. It thus creates unparalleled transparency for our clients by spotting risk and opportunities in a dynamic and timely manner based on their customized portfolios. We hereby screen all relevant sources (publications/news, social media, trade registries, video sources and any other electronic insights) based on our proprietary methodology which our team developed in the last 13 years, pioneering internationally in many respects the application of social network analysis to the investment industry.

Disclaimer

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