NYSE

NYSE: Corporate Governance Guide

8 Building a balanced board

Julie Hembrock Daum, North American Leader, Board Practice Spencer Stuart

A key function of a corporate board of directors is to shape and guide its company's strategy over the long term and encourage company management to take a similarly long view when thinking about market challenges and opportunities on the horizon. In our experience, the best boards regularly evaluate their company's strategy, in light of new market developments and competitive threats. But what about boards themselves?

Board composition lies at the heart of board effectiveness. Progressive boards should continually consider whether they have the optimum composition that reflects the strategic priorities of the business and the diversity of stakeholders. The need for careful planning of board succession is greater today in light of aging boards, pressure from rating agencies, governance watchdogs and regulators, and the demand for a broader set of skills to support changes in company strategies in a fast-changing world. All boards, from major corporations to nonprofit organizations, need to demonstrate their willingness to evolve if they are to remain relevant.

The composition of the board should be viewed as a strategic asset. Boards should regularly review their makeup in light of the company's strategic direction, identify the competencies that would be valuable to find in future directors and regularly infuse the board with fresh perspectives relevant to the organization's future.

Increased focus on director tenure

A growing board composition issue is director tenure. On one hand, independent director representation on S&P 500 boards continues to grow. In 2014, the *Spencer Stuart Board Index* found that 84 percent of S&P 500 directors were independent, compared with 80 percent a decade ago. On 58 percent of boards in 2014, the CEO was the only non-independent director, compared with just 39 percent of boards in 2004. While board independence appears to be increasing, some investors have become more vocal in questioning how director independence is defined and whether independence is compromised after many years on the board. In 2014, 16 percent of boards had an average director tenure of 11 or more years, and the average tenure of S&P 500 boards was 8.4 years.

Proxy advisory firms have begun to ask how long is too long when it comes to director tenure, and some governance activists are contemplating whether length of service should be factored into definitions of independence. Institutional Shareholder Services (ISS) announced in early 2014 that it will begin to take into consideration in its QuickScore rating whether a company has "excessive" director tenure of more than nine years. According to an ISS 2013–2014 policy survey, 74 percent of investors who responded indicated that long director tenure is problematic, including 15 percent who agreed that lengthy director tenure can diminish a director's ability to serve as an independent steward, 11 percent who agreed that lengthy director tenure can limit a board's opportunities to refresh its membership, and 48 percent who indicated that they share both of these concerns.

Critics of the ISS decision cite the benefits of having long-tenured directors on the board. Long-tenured directors can bring to board deliberations valuable experience, institutional knowledge, and an understanding of the company's strategy, operations, and culture. In many situations, directors with long ties to a company can be more confident and better prepared to challenge management because of their historical knowledge than a director with less history with the company.

Currently, there are no specific regulations or listing standards in the US that speak to director independence based on tenure. And, in fact, most US public companies do not have governance rules limiting tenure; only three percent of S&P 500 boards specified a term limit for directors in 2014. Several other countries have adopted regulations linking board tenure to independence, some requiring boards to explain why a director should be considered independent after a certain tenure and others setting tenure limits after which a director can no longer be considered independent.

In the absence of tenure or term limits, many US boards rely on mandatory retirement ages to promote turnover. Seventy-three percent of S&P 500 boards have established a mandatory retirement age for directors, compared with 79 percent in 2004. But the average retirement age has crept up in recent years, as boards have raised their mandatory retirement ages to allow experienced directors to serve longer; 92 percent of boards that have established a mandatory retirement age set it at 72 or older, versus 49 percent in 2004. At the same time, boards are recruiting more retired executives than in the past. In 2014, more than half of the newly elected directors were retired. As a result, boards are getting older and longer tenured. In a world that is increasingly global, rapidly changing, and more reliant on new and innovative technology, directors may not be as current.

Diversity considerations

Boards are increasingly recognizing that boards with a good mix of age, experience, and backgrounds tend to foster better debate and decision-making and less groupthink.

In recent years, female representation on boards in particular has been a growing area of focus. In addition to shareholder and government attention to the issue, recent research continues to highlight the benefits of gender diversity on boards. For example, the 2012 Credit Suisse Research Institute report *Gender Diversity and Corporate Performance* found that, during the six-year period ending in 2011, companies with at least some female representation had better share price performance, higher return on equity, and better average growth than companies with no women on their boards.

While women serve on US corporate boards in greater numbers than in the past, female representation on S&P 500 boards has fallen behind countries such as Norway, Finland, Sweden, and France as European governments have made diversification a priority. Women now account for 19 percent of independent directors of S&P 500 companies, according to the 2014 *Spencer Stuart Board Index*, up from 16 percent in 2009 and 16 percent in 2004. Two thirds of S&P 500 companies have two or more women on the board, compared with 45 percent in 2004. Yet still 5 percent have no women.

One of the most significant barriers to increasing female representation on boards is a perception that the pool of qualified female director candidates is limited. Our experience recruiting women to boards demonstrates that qualified women are available for board roles. Between 2007 and 2012, one third of the women we recruited for board roles were top corporate executives, including CEOs, chief operating officers, presidents, or chairwomen. Divisional business leaders and general managers represent another significant source of female director talent, as do finance leaders, bankers, and auditors. As companies seek greater integration of digital, social media, and e-commerce into their business models, women are proving to be an important source of director talent. Other sources include government leaders, academics, senior consulting partners, and functional leaders.

Increasing ethnic and racial diversity is another priority for many boards. In a 2014 survey of corporate secretaries as part of the *Spencer Stuart Board Index*, minorities, women, and sitting CEOs topped the list of the most desired profiles for director recruitment; 64 percent of respondents indicated that recruiting minority directors was a priority. However, recruitment of minority directors has not kept pace with demand. Among all directors for the top 200 companies of the S&P 500, 9 percent are African-American, 5 percent are Hispanic/Latino, 2 percent are Asian, and 8 percent are from outside the US.

Another consideration is whether to add an international business perspective to the board. For example, it can be valuable to have one or more directors from strategic markets or with working experience in those markets if the company is expanding its global footprint, building manufacturing or distribution capabilities overseas, or moving into a complex or particularly competitive market. International directors remain a small minority on US boards, accounting for just 8.1 percent of directors on the top 200 S&P 500 companies. Forty-five percent of those 200 companies do not have an international director.

It is important to point out that boards do not have to sacrifice critical skills or expertise to increase diversity, but they may have to broaden their approach to director recruitment and their perceptions about the ideal director. Boards often define the ideal board member as a current or former CEO or CFO, and women and minorities are still underrepresented in these ranks. In addition, some boards still look for director candidates within their own personal and professional networks, and these networks may include few women, minorities, or leaders from outside the US.

Succession planning for the board

In the past, boards had a tendency to replace a retiring director with an individual "who looks like the person who left" or allowed the chief executive officer to take the lead in filling board seats. Today, of course, boards no longer cede responsibility for director recruitment and succession planning to the CEO, yet they often address director succession only on an as-needed basis—when facing an impending vacancy.

This approach, however, may put boards at a disadvantage in this time when growth and innovation are top priorities for most organizations. Facing new global and competitive challenges, companies are transforming themselves through new product strategies, different product mixes, and expansion into new markets and geographies. In an ideal world, outside directors with relevant experience can serve as valuable advisers to the board and management about the company's market, geographic, and product directions, as well as providing a sounding board for management on the critical issues the company is likely to encounter. Wise boards will want to foresee where the company is headed in the future and have individuals on the board with the expertise to help the company move in that direction as efficiently as possible. Boards can accomplish this by vigorously managing director succession.

External forces, too, encourage a more proactive stance on board succession planning. Investors have become a potent voice in board governance, holding directors accountable for company performance and even challenging the nominations of directors. Institutional investors, on the whole, are looking for board directors who are independent from management and possess the relevant business and financial experience. Furthermore, boards that plan for director departures will be better positioned to recruit directors with the desired experience.

Director departures or retirements create openings that enable the board to expand or strengthen its skills in certain areas. Boards should take advantage of natural attrition to recruit directors who can add valuable perspectives about the company's strategic direction, bringing on, for instance, directors with experience in a particular market, industry, or business model.

Developing a skills matrix

As a starting point, the board should stay up to date on the timing of anticipated vacancies, including those due to directors' plans for retirement, term or age limits, and the needs of individual committees for specific expertise. In most cases, director departures are known well in advance, giving the board the opportunity to plan for specific board openings. Boards also should proactively review their composition periodically to ensure that they continue to have the right mix of expertise in light of the company's strategic direction.

When working with clients on this exercise, Spencer Stuart often uses a board profile matrix to examine the demographics and professional backgrounds of current board members and identify gaps or voids in the board's composition. As the board reviews topics such as the businesses in which the company competes, strategies to grow profitably, and competitive threats, it is natural to consider whether the board as a whole includes the expertise and skills that it will need to help the company deliver on its strategic vision. If skills gaps are identified, they can be used to help shape the search for new directors when vacancies occur or signal a need to expand the board. Increasingly, boards are sharing their thinking about board composition and how the qualifications, skills, and attributes of individual directors satisfy the defined set of skills for the board by including a skills matrix in the annual report.

The skills matrix should take into account regulatory and listing requirements, committee needs, the strategic direction of the business, and the appropriate diversity of perspectives.

Strategic considerations

Some boards are prioritizing new areas of expertise when recruiting and tapping nontraditional candidates, especially younger, active executives, to bolster their knowledge in disciplines such as digital or social media, certain areas of finance and emerging markets, or global business. We continue to see an increase in the number of new directors who are serving on an outside public board for the first time—39 percent of new directors were "first-time" directors in 2014, compared with 30 percent in 2012, as boards bring on younger executives with these capabilities.

Director independence requirements

According to NYSE Euronext guidelines, at least three quarters of the board members must be independent, and all members of the audit, human resources and compensation, and nominating and governance committees must be independent. Boards must affirmatively determine that directors who are classified as independent have no material relationship with the company, either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company. The nominating and governance committee is responsible for reviewing the qualifications and independence of directors and board committees on a periodic basis, as well as the composition of the board as a whole. This assessment should include members' qualifications as independent, as well as consideration of diversity, age, skills, and experience in the context of the needs of the board.

Committee needs

The matrix should also include consideration of the board's committee requirements. Knowledgeable, independent directors are needed to lead and serve as members of the audit, compensation and nomination, and governance committees. The chair, especially, must be current on the relevant governance issues and trends. Retired CEOs, chief operating officers, and chairs are a growing source of audit committee chairs, as are active and retired finance executives. Retired and active CEOs and COOs are often tapped to chair the compensation committee.

Diversity

One important category in the matrix is diversity. Rather than being considered an end in itself, diversity is increasingly considered an underlying criterion when potential directors are sought for skills or experience. More and more, boards recognize that having diverse perspectives on the board—in the areas of age, gender, race and ethnicity, and, in some cases, geographic knowledge—expands their views on issues, options, and solutions. The ideal board mix will vary depending on the needs of the company and could include directors with significant public company board experience, directors with relevant sector and geographic experience, and directors with international business experience.

Today, most boards start planning for vacancies at least 12 months in advance and, in cases when several retirements are on the horizon, boards think holistically about a multi-year process. The process begins with the board reviewing and confirming the desired expertise and qualifications for new directors, identifying potential director candidates, and reaching out to candidates well in advance to let them know the board's interest. It may be helpful to tap external resources at the point when specific vacancies are nearing. For example, through their work with boards and top executives, search consultants often know on a confidential basis the plans of many senior leaders. Particularly in the case of CEOs, who are often inundated with board invitations, it is valuable to understand their restrictions and preferences for outside board service, as well as their retirement plans. A search firm often has the ability to discreetly test executives' interest in a new board role and his or her future availability, and also to look globally at new, younger candidate pools such as executives with digital experience.

Role of director evaluation and director development in building a balanced board

A board can position itself to refresh and recruit directors with the desired experience by regularly reviewing its composition. The

Table 1 Developing a skills matrix

- Think holistically about director recruitment as opposed to one-off recruitments.
- Develop a matrix of the overall skills and experience required for the board based on an analysis of the skills and experience necessary to support strategy.
- Inventory the skills, contributions, and diversity of current board members to identify any gaps to be filled.
- Use a skills matrix to ensure the bases are covered when recruiting.
- Outline specific requirements for key committee chairs.

annual board evaluation is a natural platform for the full board to review its composition and discuss the expertise that it will need in the future. Through the evaluation, individual directors and the board as a whole can identify the areas of knowledge the board should possess in the coming years based on the company's strategic direction and the competitive landscape. From there, the board can evaluate whether it currently includes individuals with the relevant backgrounds and, if not, what skills or experience would be valuable to seek in new directors when vacancies occur. A growing number of boards conduct individual director assessments to understand the performance and contributions of each director to help improve individual performance and to encourage appropriate turnover.

Conclusion

Forward-looking boards elevate the task of planning for director succession. They engage in an ongoing review of the board's skill-sets relative to the company's strategy and direction and find opportunities to acquire the necessary capabilities and experience. As they become more proactive in this area, boards will ensure the board as a whole, and directors individually, have the energy, expertise, and experience to guide the organization as it addresses new challenges and market opportunities. In our experience, the most effective boards do the following:

- Carefully define the expertise that is important for the board—for example, industry or functional knowledge or international business experience.
- Cast a wide net for director candidates with the goal of identifying the best candidate—not just the ones known to board members.
- Have a good reason why each director belongs in the room. Be clear about the perspective or expertise the individual contributes.
- Keep an open mind about what a director should look like and the different ways directors can contribute. Boards can widen their net by looking at retired executives or senior business unit or functional leaders, who may not have the breadth of experience of a CEO but can bring valuable knowledge in specific areas.
- Establish a strong new director orientation program. All first-time directors benefit from an orientation and ongoing training that helps them quickly get up to speed on the business and the company's approach to governance.
- Understand your board's culture and assess candidates for their fit.
- Continuously review the board's skill-sets and performance relative to the company's strategy and direction to ensure that the board as a whole has the knowledge, experience, and skills to guide the management team as it addresses new challenges and market opportunities. In addition, this will ensure that every director is contributing. The annual board evaluation is a natural platform for the full board to review its composition and discuss the expertise that it will need in the future.

Spencer Stuart

353 N Clark, Suite 2500
Chicago, Illinois 60654
Tel +1 312 822 0088
Web www.spencerstuart.com

Cathy Anterasian

North American Leader, CEO Succession Services
Email canterasian@spencerstuart.com

Ms. Anterasian leads CEO Succession Services for Spencer Stuart in North America. She is an active member of the North American Board, CEO, Technology, Media & Telecommunications, and Consumer practices. Previously she launched and co-led Spencer Stuart's global Executive Assessment Services practice. Ms. Anterasian has more than 25 years of experience in succession planning, assessment, executive search, and strategy consulting. She advises boards and chief executive officers on the capabilities and potential of their teams, as well as on the development of strategies and plans to prepare executives for CEO succession and other C-suite roles. Ms. Anterasian has partnered with numerous boards and CEOs of Fortune 500, mid-cap, and privately held companies to ensure that successful leadership development, selection, and transition occur. She has engaged with clients globally across financial services, life sciences, industrial, technology, retail, and consumer sectors.

Julie Hembrock Daum

North American Leader, Board Practice
Email jdaum@spencerstuart.com

Ms. Daum leads the North American Board Practice and serves on the board of directors of Spencer Stuart. She consults with corporate boards, working with companies of all sizes from the Fortune 10 to pre-IPO companies, and has conducted more than 1,000 board director assignments. A recognized expert on governance topics, Ms. Daum helped found and develop the Wharton School's Corporate Governance: Fresh Insights and Best Practices for Directors program and is regularly quoted in The New York Times, Financial Times, Businessweek, Time magazine, and The Wall Street Journal. She is also the coauthor of the recent business book You Need a Leader—Now What? How to Choose the Best Person for Your Organization.

Dayton Ogden

Global Leader, CEO Succession Services
Email dogden@spencerstuart.com

Mr. Ogden is the global leader of Spencer Stuart's CEO Succession advisory services and a member of the Board and Industrial practices. His search-consulting work focuses on senior executive and board recruiting for international clients. He is commentator on key trends and issues affecting CEOs and boards, both in the US and internationally. In 2000, Oxford University Press published CEO Succession, which he coauthored. Mr. Ogden draws from direct board experience for client work, currently serving on the board of the American Business Conference, an organization that includes the CEOs of emerging growth companies. He is also secretary and a director of Project HOPE, a leading health-care foundation based in Washington, D.C. Mr. Ogden was elected chief executive of the firm in 1987 and in 1993 became the first CEO in the firm's history to be re-elected to a third term. He served as chairman from 1999 through 2006.

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- Navigating the changing landscape of corporate governance
- Selecting and developing a high-quality board
- Implementing risk-management controls
- Overseeing a succession plan for senior management
- Communicating effectively with shareholders
- Assembling a comprehensive ethics and compliance program

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