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On the board's agenda | US

Board composition: Greater than the sum of its parts

Boards of directors have been around for a long time. So have annual meetings, when shareholders are asked to elect directors, and proxy statements, where information about the candidates' backgrounds and qualifications is provided. Thus, it might be somewhat surprising that board composition has become a very hot topic with investors, regulators, and others in the governance community — as well as in boardrooms.

On the other hand, ongoing regulatory changes, pressure from shareholders and investors, and business model threats are pressuring many companies to examine their board composition. And board composition is extremely important — arguably one of the most critical component of a corporation's governance — so it is only fitting that this is a topic on the board agenda.

Board composition is made up of many parts. Skills and qualifications, independence, diversity, tenure and refreshment will be outlined as topics for the 2016 board agenda.

Skills and Qualifications

A director's qualifications to serve on a board are key. Securities and Exchange Commission (SEC) rules have required disclosure of directors' biographical information for many years, generally in the form of a five-year employment history. In 2009, the SEC expanded the proxy rules to require companies to "briefly discuss the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director…"[1] This "skill set" disclosure generally appears in a short paragraph or a series of bullet points following each director's biographical information, indicating what the person brings to the board, such as international, management, or financial skills or other types of experience. Despite this expanded disclosure, many institutional investors and others continue to question why members of the board have been selected.

[1] Item 401(e)(1) of SEC Regulation S-K

In response to these concerns, some companies have provided a "skills matrix" in their proxy statement. While skills matrices can be useful, their use as disclosure tools — or as a means of objectively assessing board composition — may be problematic. Defining a director's skills is not as easy as it may seem using simple terms in the matrix including technology, international or leadership. Without the director's full resume, understanding a director's skills based upon a simple word is difficult.

Other companies have developed a skill set graphic to illustrate the "collective" skills possessed by the board as a whole, without attributing specific skills to individual board members. Some institutional investors prefer this approach, as it reflects the abilities of the full board, rather than the skills of each individual board member. Companies should consider clearly communicating their individual board attributes, remembering that the goal is to have the proper individuals with the skills and qualifications necessary to empower the board to properly oversee and advise management.

Independence

Independence is another key attribute of board composition, as the New York Stock Exchange (NYSE) and NASDAQ require listed companies to have a majority of independent directors. Independence is the absence of relationships between the company and the director that would impair the director's independent judgment. The exchanges have developed a series of "categorical" standards that are designed to make independence assessments more objective.[2] Some companies follow only these standards, while other companies, as well as some investors and proxy advisory services, have implemented their own, often more stringent, standards.

Independence standards are not new, but continue to evolve as additional requirements, including the Sarbanes-Oxley Act, new NYSE requirements, and the Dodd-Frank Act have been introduced. Another factor is that directors' independence may be challenged by shareholders when past decisions have gone awry. One challenge has been independence without industry experience. An independent board lacking industry experience may not have the ability to effectively question and challenge management.

One final independence concern is that while a director may meet the independence requirements from the SEC or NYSE, he or she may not be independent in thought and action — i.e., reluctant to challenge management, ask tough questions and get satisfactory answers — attributes that are difficult to measure. Shareholders continue to focus on the importance of a board that includes independent directors with the proper industry expertise, ability to ask tough questions, and challenge management.

Tenure and Refreshment

Many investors are increasingly pressuring companies to refresh their boards, that is, bring on new board members. The issue of tenure and board refreshment and how it influences overall board composition and independence is something that many companies and their boards have been discussing for a very long time. Average board tenure for the Fortune 100 has decreased over the past five years from an average of 9.2 years in 2010 to 8.9 years in 2014.[3]

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[2] Section 303A.02 of the NYSE Listed Company Manual

[3] Equilar *The Changing Face of Fortune 1000 Boardrooms in Five Charts* http://www.equilar.com/blogs/48-the-changing-face-of-fortune-1000-boardrooms.html

One option for effecting board refreshment is to implement age-based mandatory retirement policies. The 2014 *Board Practices Report* published by the Society of Corporate Secretaries and Governance Professionals in collaboration with Deloitte LLP's Center for Corporate Governance (*Board Practices Report*) reports that 72% of the top 250 companies have such policies. While this represents a decrease from 82% in 2012, there seems to be ongoing "age creep" — according to the *Spencer Stuart 2015 Board Index*, 34% of the companies with mandatory age requirements now specify an age of 75 or higher, up 325% from ten years ago.[4] In other words, as the directors age, the age limits keep rising. The increasing age limits are being offset by younger board members, however, as the average board director age at Fortune 1000 companies has decreased by three years to 63 as of 2014, down from the age of 66 in 2010.[5]

A second option is to implement term limits. According to the *Board Practices Report*, term limits have not been common for companies, as only 6% of the companies surveyed reported having term limits[6] and another 5% of the 2015 *Board Index* survey respondents reported that their boards are considering term limits.[7] However, the GE board recently updated its Governance Principles, including a provision that all directors, other than the Company CEO, will have a term limit of 15 years.[8]

Enhanced board evaluation processes — particularly individual director evaluations — provide a valuable third option for addressing board tenure and refreshment. Board evaluations provide an opportunity to gauge the effectiveness of the board. The NYSE requires the nominating and governance committee to oversee the evaluation of the board and management, and for each committee to perform a self-evaluation[9], however there is no requirement to perform individual evaluations of each board member.

Of the S&P 500, 98% of the reporting boards responded they conduct an annual performance survey, with 33% reporting the company reviews the full board, committees and individual directors.[10] According to GE's *Governance Principles*, board evaluations will be an important determinant for GE's board tenure.[11] Ultimately, evaluations of individual directors and candid post-evaluation conversations by the Chairman or Lead director may help ensure strong performance and movement off a board if it is not being achieved.

Over time, better orientation and education programs may also lead to an understanding that board membership is not expected to be a lifetime position, and possibly more robust director self-evaluations will likely result in more candor so as to make it possible to tell a director that it's time to go.

In the absence of these or other developments, some institutional investors and proxy advisors are applying pressure for board refreshment. Institutional Shareholder Services (ISS) has a policy — not yet part of its voting guidelines — that any director who has served more than nine years has "compromised" independence. State Street Global Advisors has adopted a similar approach and is also focused on whether long-tenured directors serve on the Audit, Compensation and/or Governance Committees.[12] And very recently, both the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) have announced policies questioning whether a director serving more than 10 years can be deemed independent.[13]

[4] *2015 Spencer Stuart Board Index* page 7

[5] Equilar *The Changing Face of Fortune 1000 Boardrooms in Five Charts* http://www.equilar.com/blogs/48-the-changing-face-of-fortune-1000-boardrooms.html

[6] *2014 Board Practices Report* Society for Corporate Secretaries and Governance Professionals and the Deloitte Center for Corporate Governance page 17

[7] *2015 Spencer Stuart Board Index* page 14

[8] See GE's *Governance Principles* as of 12/15/2015 https://www.ge.com/sites/default/files/GE_governance_principles.pdf page 3

[9] New York Stock Exchange *Corporate Governance Standards* as of 12/18/2015 http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F4%5F3%5F5&CiRestriction=evaluation&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F

[10] *2015 Spencer Stuart Board Index* page 29

[11] GE's Governance Principles as of 12/15/2015 https://www.ge.com/sites/default/files/GE_governance_principles.pdf page 3

[12] See State Street Global Advisors Proxy Voting and Engagement Guidelines, at https://www.ssga.com/investment-topics/environmental-social-governance/2015/Proxy-Voting-and-Engagement-Guidelines-United-States.pdf

[13] See https://www.calpers.ca.gov/docs/board-agendas/201511/globalgov/item04a-01.pdf

As noted, companies have discussed this issue for some time, and some have actually developed alternative approaches. Some companies have committed to keep average director tenure at or below a specified level, assuring that effective, long-tenured directors can remain on the board so long as the average tenure remains reasonable by bringing on newer directors. In other cases, companies have offered to have long-tenured directors meet with institutional owners; this type of director engagement can provide assurances that the director is sentient, articulate and capable of providing value to the board — and the Company's shareholders and other stakeholders.

Diversity

Unlike the criteria discussed above, the topic of diversity is the "newest" significant factor in evaluating board composition. Similar to skills and qualifications, "diversity" can be defined in various ways. There is diversity of thought and action, mentioned above, as well as diversity of gender, ethnicity, and generation.

As there is considerable support for boards to become more diverse, several countries, including Norway, France, Spain, and Sweden, have enacted laws requiring boards to have specified minimum percentages of women. The 2020 *Women on Boards Gender Diversity Index* indicated that the percentage of women on Fortune 1000 US boards rose to 18.8% in 2015, up from 17.7% in 2014. The percentage increase continues to rise toward their goal of seeing 20% or more of company board seats held by women, by 2020.[14]

Many companies have traditionally sought current or former CEOs to serve on their boards. This tradition continues, according to the 2015 *Spencer Stuart Board Index*, which reports the top three items on the wish list for new director backgrounds:

Wish List for New Director Backgrounds[15]

	2015	2014
#1	Active CEO/COO	Women
#2	Women	Minorities
#3	Financial expertiste	Active CEO/COO

Women, minorities, and younger generations represent a smaller percentage of CEOs, therefore they are not typically part of the traditional population of board candidates. Identifying skills and qualifications to connect to trends shaping the business, including technology, globalization, consumer preferences, and business strategy can help the board add diversity to discussions. Generational diversity has been slow-moving; however in 2014, Wal-Mart added 30 year-old Kevin Systrom, former CEO and co-founder of Instagram, to its board of directors, as the company was looking for a director with technology experience.[16]

Board composition is not susceptible to a one-size-fits-all approach.

Conclusion and Further Thoughts

Board composition is not susceptible to a one-size-fits-all approach. It reflects a mix of director skills, independence, diversity, and tenure, each of which has its own complexities. Individual personalities and how the directors interact with each other and with management are also critical components of board composition — and are difficult to measure or to objectively assess. One tool that can be considered is business chemistry — a process that might be applied to assess individual directors' personality types and thus better measure their intellectual independence as well as their ability to work as part of a collegial team. Business chemistry and its use as a board tool will be addressed in a subsequent article.

Boards should consider their composition to ensure they have the right skills and experience to allow for diversity of thought, varying perspective, and innovative, strategic discussions.

[14] *2020 Women on Boards Gender Diversity Index 2011-2015 Progress of Women Corporate Directors by Company, Size, State and Sector*

[15] 2015 and 2014 Spencer Stuart *Board Index* pages 11 and 12, respectively

[16] *Wall Street Journal,* September 29, 2014

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