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SPECIAL REPORT

Q&A: Board composition

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Q&A

Board composition

FW moderates a discussion on board composition between Sarah K. Stewart at Boyden, Deborah DeHaas at Deloitte LLP, Steven R. Walker at the National Association of Corporate Directors, and Margaret Pederson at Women Corporate Directors.

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FW: Given the board's ultimate decision-making authority, how important is it at a senior level to have the requisite balance of skills and abilities in place to drive corporate strategy?

DeHaas: A key responsibility of the board is to advise management on the development of the company's short and long term strategic priorities, approve such strategies, and ultimately oversee the execution of the strategy. To do this effectively, boards should consider whether they have the right processes in place, as well as the right capabilities and diverse perspectives among both senior management and the board. Furthermore, a board with members who are able to challenge management and one another on strategic alternatives, who understand strategic risks, and who offer new ways of thinking about related opportunities and challenges could be beneficial. Aligned with the discussion of specific skills needed to drive a successful strategy is the importance of representation of the company's constituents, for example, customers, employees and investors. Hence, a board rich in diverse experiences and skills can provide unique and 'outside-in' perspectives and strategic thinking across a broad range of initiatives.

Walker: Ideally, a company's board composition will mirror its strategic future. Clearly, the experience, skills and

judgment of the men and women around the table matter. They affect the quality of the board's involvement in strategic planning and the wisdom of the board's strategic decisions. In our annual corporate governance surveys, we ask directors to rank the issues of greatest concern to them. Invariably, strategy ranks first, even before corporate performance. Why? Because in the long term strategy drives performance, and good directors serve for the long term.

Stewart: In order to be highly effective, the board should have a diverse mix of experiences to draw from when evaluating corporate strategy. It is equally important to have a management team that has the ability and competencies to not only drive the strategy, but to create it. The board's engagement in strategy falls along a spectrum. At large global companies with a management team that has broad and deep skills, the board's role is to understand, challenge, enhance and approve the strategy. At smaller companies, directors may have an opportunity to influence strategy earlier in the process. However, when large company directors feel a need to insert themselves into the development of strategy, it calls for either a change in directors or a change in the management team.

Pederson: As a director, industry and functional experience are valuable in informed decision making. It is challenging to understand all the components and complexity involved in setting strategy without a strong understanding of the fundamentals driving the business, as well as the competitive and technological developments impacting future options. Understanding the implications and potential ramifications – deliberate and otherwise – of various tactics and strategies is key, especially in fast changing environments or regulated, scientific and technical fields.

FW: In your experience, are there any major differences between how a board should be composed in the public as opposed to the private sector? How does the increasing amount of regulatory scrutiny impact this issue?

Walker: The best private companies and boards recruit as if they were planning to go public, with an eye to sustainable long-term value. So ideally, *ceteris paribus*, the differences will be minor; however, there is a twist. By definition, public companies sell their shares to the public, rather than to a small group of personally known or financially sophisticated individuals. As such, their boards are subject to a more stringent set of standards, such as the expectation in the US that they will have a majority of independent directors and that their key committees will be composed entirely of independent directors. For public companies, this puts a premium on independence, which in some cases can weaken the industry expertise of the board, since industry insiders are less likely to be considered independent. Public company boards must make a special effort to identify individuals who have both independence and relevant industry knowledge.

Pederson: Boards benefit from comparable composition and skills regardless of whether they are public or private. However, how a board functions and where it focuses its resources varies depending on whether it is a public or private firm and the level of regulation in the particular industry. Public boards must spend considerable time on regulatory issues that are not germane to private firms, which can spend more time on strategy. At an extreme, some public companies must spend 60 to 80 percent looking backward on financial and regulatory performance, whereas private companies can spend more than 70 percent on current and future business initiatives. Therefore, individuals tend to gravitate to one type of board or the other partially based on experience – their background in public or private enterprise – and preferences in the business areas where they focus their time.

Stewart: Every large private company is likely to want the board to function as closely to the public company model as possible. The most progressive private companies followed the best governance practices before they were codified into law. Some regulations apply to all companies regardless of ownership structure; however, at the end of the day, private companies do have more freedom to decide whether a particular best practice adds value or impedes the business. Regardless, private companies need to keep up to date with changing interpretations of regulation. For example, a recent US Supreme Court ruling requires that private companies comply with whistleblower laws just like public companies.

DeHaas: One significant difference between public and private company boards is that private company boards may not employ governance practices that are as formal; they do not have listing standards, SEC and other regulatory requirements to adhere to, such as having certain board committees, director independence and diversity disclosure. Also, private companies tend to have a greater number of inside directors on their board. None of this necessarily translates to a less effective board, however private companies can still consider adopting public company governance practices and standards. In particular, having more independent and

diverse directors may help contribute to fresh perspectives and enhanced dialogue in the boardroom. This can also contribute to a greater alignment of board composition to company strategy and possessing the skills and experience needed to advise on the development of strategy and overseeing its execution.

FW: To what extent does strong board composition lead to better corporate governance and a greater understanding of compliance requirements among senior staff?

Pederson: Strong board composition and knowledge of governance provides the background to understand compliance requirements which are becoming increasingly complex. Outside advisers can provide beneficial expertise, yet the board and senior staff need to be able to effectively direct and evaluate this effort.

DeHaas: The board plays a critical role in vital company matters, such as advising and ultimately deciding on company strategy, setting ethical expectations of employees, overseeing various possible risks, and hiring and firing, evaluating and compensating the chief executive officer (CEO). A strategic and thoughtful approach to board composition can make a difference in how well these and other governance related matters are executed. For example, having board members with strong compliance and regulatory experience may be helpful in understanding applicable compliance matters and related management reports, fostering productive discussions with management, and even further, creating meaningful impact on the overall ability and culture of the company in managing these critical areas. Effective board oversight can be driven by appropriate policies and processes that allow the board to make informed decisions and provide proper advisement to management. This is greatly impacted by the tone set by the CEO, chairman or lead director, and robust onboarding of new members so that all are on the same page regarding expectations and responsibilities.

Stewart: To some degree, we take it on faith that having seasoned leaders on the board with experience relevant to the company, and who are committed to the principles of good governance, will result in a better managed company and superior performance. Here's a real life example that illustrates how the board can positively influence senior management's fulfilment of compliance obligations: the chief auditor at a regional insurance company recently explained how the higher expectations of the board's new audit chair, a financial executive from a large, global consumer company, raised the bar on the internal audit team, resulting in a more rigorous, progressive and effective approach.

Walker: Strong board composition can foster better governance and strong compliance but it goes beyond these elements. A board that has a strong composition will seek a range of backgrounds and skills. This in turn enables a balance of risks and rewards. Corporate governance and oversight of compliance can mitigate risks, but what about increasing rewards? Governance and compliance alone will not generate those. Strong board composition must include a commitment to business success, which means moving forward into new and expanding, value-creating realms while taking calculated risks. While governance and compliance are important, they are secondary to this primary imperative of creating and sustaining business growth on behalf of shareholders and all stakeholders.

FW: In terms of the advancing technological landscape (taking in social media, virtual communities, social networking), how are boards responding? What impact are these developments having on board composition?

Stewart: Many boards could stand to do a better job of succession planning for themselves which would force directors to recognise potential future trends and challenges that call for a new set of skills. Most boards are playing catch up with regard to the technology affecting how, at a fundamental level, companies are doing business and relating to customers and employees. Like the old IBM board, made up of directors who had never used a computer, boards are made up of directors who lack a personal knowledge of the latest advances. We are definitely beginning to see boards reaching for directors who bring a first-hand perspective on social media and other new technologies, many of whom are younger and who don't match the description of the traditional operating, CEO-type.

Walker: Boards today have gone virtual in how they receive, study and modify their materials. While many companies still provide their boards with the classic printed 'board book', most boards now have a secure board portal for storing and accessing their materials. Directors using portals will bring their tablet devices into the boardroom in order to refer to their materials. In some cases, directors will use a search engine during the meeting to obtain additional information or check facts. This can be a powerful tool for making decisions in real time, but it can also be a distraction. There is also a slight risk of security breach through hacking. The board chair needs to set the tone for an orderly and focused meeting amidst potential distractions. As boards select new directors, in a choice between two equally qualified individuals, they may prefer one who is comfortable with technology. At the same time, boards would be wise to avoid individuals who are so enamoured of their devices and connections that they cannot concentrate in a 3D setting with real people.

Pederson: More boards are looking for a digital expert as a member to provide such expertise, which can lead to younger, more tech savvy individuals with non-traditional board backgrounds joining boards. Without that expertise, boards need to rely on management and outside digital consultants to provide that expertise. Some boards are doing training to help less digitally savvy board members get up to speed, including providing reverse mentoring where a younger colleague provides guidance.

DeHaas: In a recent Deloitte survey of board practices, conducted in collaboration with the Society of Corporate Secretaries and Governance Professionals, 27 percent of those public company corporate secretaries surveyed said their boards receive reports on company social media usage, 33 percent of boards have been educated on data analytics, and 42 percent said board awareness on cyber security is high. None of these results represent a majority, yet boards and their management teams are recognising the impact that technology places as both a strategic opportunity and a potential risk. In fact, as technology topics rise on boardroom agendas, more boards, particularly those in the tech industry, want to hear from their chief information/technology officer, or their equivalent, on topics like IT strategy, cyber and social media. To stay further informed, some boards utilise third-party advisers to educate them on leading practices, and others assess the need to add related skills to their composition.

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FW: In your opinion, are boards giving proper consideration to succession planning? Is a significant change in mindset required?

DeHaas: Most boards understand their critical responsibility of selecting, evaluating, compensating and terminating the CEO, and sometimes even the broader C-suite. Where some may fall short is having a robust, formalised succession process – which could be detrimental upon a sudden departure. At a high level, a typical process would likely entail the board, most often led by the compensation or governance committee, reviewing and approving, on an annual basis, the succession plan put forth and executed by the CEO. A robust plan would account for a 'black swan' scenario in which an abrupt, unplanned departure occurs, such as a death, and for a long-term departure. It would also include potential or sources of potential candidates whom the CEO would be responsible for grooming and developing, if internal, with full board oversight. There have been shareholder proposals calling for succession plan disclosure, which is yet further reason for boards to give proper consideration and attention to the process.

Stewart: For years, directors have named CEO succession planning as arguably the board's most critical responsibility. At the same time, a disturbing number of directors admit that they don't spend enough time on succession planning and don't do it well. That is a huge disconnect. Directors need to bridge the gap between understanding how important succession is to protecting the business and insisting that it be done. Cue the institutional investors whose demands for more transparent disclosure in the proxy are making it increasingly difficult to forestall dealing with the issue.

Walker: Succession planning for CEOs is top of mind for a significant number of boards. In our most recent survey of public company directors, it ranked third after strategy and performance, with nearly one-third of respondents identifying it as a 'top three' issue. CEO succession even edged out the increasingly urgent topic of risk oversight by a few percentage points in this regard. The main finding in that survey was that satisfaction increases with formality – 90 percent of directors with formal plans for CEO succession were satisfied and only 10 percent were dissatisfied. For directors with informal plans, the balance of satisfaction versus dissatisfaction was 66 to 34. Succession planning for boards landed somewhat lower as a major issue, ranking fifth for large cap companies, after talent development, and even lower for smaller firms. We do have a new survey out in the field now and are seeing continuing interest in succession planning. Regardless of ranking, succession planning is a sensitive and complex matter – especially for boards, which have multiple individuals and interactions to consider.

Pederson: Hiring the CEO and effective succession planning is one of the primary responsibilities of the board of directors. It is good governance for public companies and good business for private companies. Yet, statistics indicate that many companies are not adequately prepared for succession planning. There are three core reasons for this: there is a concern that the CEO will take it as an indication that the board is looking for a management change, lack of agreement on strategic direction and lack of disciplined process for identifying and evaluating talent. Done effectively, CEO succession planning is a continuous and dynamic process that ensures business continuity. Boards need both a long term plan to deal with expected turnover, and a short term or interim plan for unexpected resignations, terminations or crisis.

FW: Replacing an underperforming colleague can be an uncomfortable, as well as a procedurally difficult task. What steps should companies take in such circumstances?

Walker: Judging the 'performance' of an individual director is not as simple as it may sound. Certainly, there are situations in which individual directors are not keeping up, but this is not always the case. The work of the board is both collective and periodic. Boards work as groups and meet several times a year, not every day. As such, the director who may seem, for example, to say too little or say too much in a particular meeting may in fact be getting it just right. There may just be an issue of chemistry with a dominant individual on the board or a clique. In that case, the problem is really with *board* performance, not individual performance. The key is to focus on process and principles, not personalities. Everyone must be treated in the same way. It is never good to go into an evaluation process with the idea of shedding a director. The evaluator should start with an entirely clean slate in which every director's skills and value are given equal consideration. Overall, when it comes to individuals, it is better to focus on fit, relative to strategy, rather than performance. The director may be performing well but may not have the particular skills now needed for the board, given its evolving strategy. A neutral outside party can help facilitate this analysis.

Pederson: Developing strong communications and a culture of directly address-

ing challenges is key; both need to be in place before there is a potential problem. An appropriate first step is an evaluation that identifies shortcomings with a plan created to address the issues of the board overall, a committee or an individual. The colleague should be offered the opportunity to correct performance; an outside adviser can develop and oversee a specific plan. When such actions do not rectify the situation then corrective action may be required. Replacing an underperforming colleague is considered an especially delicate and challenging task – in unofficial conversations among directors – especially when the group has been working together over an extended time. It is more straightforward when there is an obvious performance issue that can be addressed in a more formal manner.

Stewart: This is a tough one for boards because it's personal. Years ago, directors were comfortable letting an underperforming peer coast to retirement, especially one whose prior contributions were valued. Today, smaller boards cannot waste a single seat and higher retirement ages make keeping a director who has lost his or her currency more difficult to justify. There are things boards can do. They can nominate directors who come in with the understanding that board composition must evolve with company strategy. They can require directors to resign at retirement age and after a specified term length. While boards aren't required to use those levers, they are there when you need them. Ideally, though, boards should step up to evaluating individual directors, something that provides another rationale for having a non-executive chair who can relieve the CEO of that burden.

DeHaas: An underperforming director can pose a risk to the full board and to the company. While the removal discussion may be uncomfortable, particularly when involving longstanding directors, it may be a necessity. Establishing a process, such as a peer assessment, can be a great way to assess individual director performance regularly. It can also help re-emphasise the full board's commitment to striving to higher performance. Results, which can offer valuable and specific feedback on a director's low performance, can be helpful in supporting the substantiation for resignation or removal discussions, typically facilitated by the chairman, lead independent director or governance committee chair – individuals perhaps best positioned to set the tone and culture of board performance. Further, some chairmen maintain ongoing director contact throughout the year. This outreach process helps foster relationships with individual directors and allows for opportunities to discuss and hopefully alleviate any performance concerns or potential issues.

FW: What advice would you give companies on creating a strong and successful board? Looking ahead, do boards and companies review their processes, behaviours and culture rigorously enough to ensure favourable comparison with internationals standards, as well as their competitors?

DeHaas: Our governance framework can be used to delineate key areas of board oversight – strategy, performance, governance, talent and integrity – from areas of responsibility delegated to management – planning, operations, reporting and compliance. The framework includes a set of attributes, including skills, processes, behaviour and information, which can be used to measure board oversight effectiveness. Such tools are designed to help boards be more efficient and effective, thereby contributing to board success. Another beneficial tool contributing to board success is an annual assessment to identify areas of strength and, more importantly, opportunities to improve. The assessment should tie back to key board responsibilities defined in the governance framework, if a framework is utilised. Finally, the dynamic between a board and its management team cannot be underestimated. A collegial, respectful relationship that encourages healthy debate can promote robust boardroom discussion, better-informed decision making and ongoing dialogue on ways to achieve higher levels of performance and success.

Stewart: Companies need to find the right balance of tenure and fresh thinking, and embrace diversity in all its facets. They should focus on expertise, not title, when recruiting new directors. They should consider naming a non-executive chair. Companies should give directors information that informs and enlightens, and make room for freewheeling discussion at board meetings by decreasing presentations. Directors are very much aware of what is happening outside their boardrooms and countries. There are leaders and followers with respect to governance practices among US companies. US directors are watching international practices closely because that is where the evolution in governance is moving more quickly. While the concepts of diversity quotas and non-executive chairs remain a tough sell in the US, other changes have made their way from the UK and Europe to our shores. We've seen it happen with say-on-pay and proxy access. More recently, the increasing access that investors have to board leadership abroad will have an influence on US practice.

Pederson: Diversity of expertise with appropriate industry and functional experience is important. Accepting non-traditional board members who bring new skills – digital, cyber security, global – allows boards to more comprehensively address emerging and timely issues and opportunities. Directors should bring skills and a profile that complements the CEO. Accepting diversity of opinion, an openness to embrace change and innovation, even when it creates tension in the boardroom, can help boards thrive in a rapidly changing world, one in which disruptive technology, quickly changing competition, and activist investors are the norm and not the exception.

Walker: Across companies, across industries and across national boundaries, boards and committees need above all a rigorous, continual process to evaluate themselves as a group. This is generally done by setting goals, by asking what the board and each of the committees plan to do. It also means measuring accomplishments, by asking whether they did it well. They also need to identity the types of skills, knowledge, and experience the board needs to do its work. Benchmarking services are available, but processes, behaviours and culture will take care of themselves if directors make an honest effort to fulfil their roles. Directors must accomplish a significant number of important tasks. For example, they must select, evaluate and compensate the CEO and senior officers, help develop and monitor the strategy of the company, monitor corporate financial performance, oversee internal controls and financial reporting and hire the auditor, oversee legal compliance generally, review and approve key regulatory filings, declare dividends, and more. They can be judged on the basis of their performance in these areas – and individuals can be judged based on their leadership roles – such as the role of chair, lead director or committee chair. An external adviser can help boards evaluate their own work in this goal-oriented fashion. ■