Lead Director Network
ViewPoints

April 22, 2015

Refreshing the board

On March 17, 2015, Lead Director Network (LDN)[1] members met in New York to discuss different approaches to refreshing the board. This *ViewPoints* presents a summary of the key points, along with background information and selected perspectives that members shared before and after the meeting.[2]

For further information about the LDN, see "About this document," on page 10. For a list of participants, see Appendix, on page 11.

Executive summary

Lead directors shared ideas and practices on three broad topics in their discussion of board refreshment:

- **Board composition** *(page 2)*

  Investors are putting more pressure on boards to think like owners as they oversee management. In response, boards are taking steps to ensure that they are composed of non-executive directors who can guide the company and its strategy into the future. In many cases, this means considering new directors who have different professional skills and experience or can enhance board diversity with respect to age, gender, and ethnicity. Directors highlighted the benefits of adding new members who can bring fresh perspectives to boardroom discussions.

- **Director selection** *(page 5)*

  A board must be small enough so that each director feels ownership of the strategy and responsibility for the major issues the company faces without being overwhelmed by the workload. In most cases, the size of the board is not constant and can grow or shrink to meet the needs of a company, its directors, and other stakeholders. When a company chooses to add a new director, the lead director plays a central role as part of a recruiting team that involves other directors and managers, often with the assistance of a search firm. Recruiting is a two-way process in which the board and the candidate must become comfortable with each other to preserve collegiality and board chemistry.

- **Assessment and turnover** *(page 7)*

  As boards consider the skills and experience they need for the future, they must also question whether existing directors still provide enough value to remain on the board in an era in which average board tenure will increasingly come under the microscope of investors. Though age limits are still the leading mechanism for board turnover, board directors are open to alternative ways to refresh their ranks, including term limits and average tenure targets. Boards are also implementing more robust evaluation

[1] Lead Director Network documents use the term "lead director" to refer interchangeably to the titles lead director, presiding director, and non-executive chair, unless otherwise stated.

[2] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

processes that often include individual director evaluations. The result is that in many cases underperforming directors are either improving or leaving the board.

Board composition

Changes in a company's strategy and business, especially in the context of a rapidly changing corporate landscape, may mean that the skills and experience that would have been sufficient for a director a decade ago are no longer enough. Lead directors discussed the steps their boards are taking to make sure they have the right mix of experience and perspectives to be effective.

Responding to attention from investors

Members said that investors are focusing more attention on board composition. One member said, *"Some investors are thinking more like long-term owners, and that means they want more say in who represents their interests."* Members said that boards are hearing this message and are responding by improving their performance. One lead director said, *"Boards are paying more attention to this issue than ever before. We are trying to stave off the idea that we don't think like investors."*

Investors have intervened at even the largest public companies to show dissatisfaction with board makeup. For example, early last year, two of Apple's leading shareholders publicly criticized the company because seven of its eight directors were white males over the age of 50.[3] In response, the company amended its nominating committee charter to demonstrate its commitment to board diversity. Then, when faced with its next board vacancy after the amendment, it appointed a second female director.[4]

While activist investors are usually motivated by underlying performance or financial issues, they often highlight issues like board composition to gain the support of other shareholders.[5] One member said, *"We have to realize that activists are a big part of this game today. They are focused on board composition."* For example, activists often raise concerns that a board lacks certain skills or expertise – such as industry experience – and identify their own nominees to fill those gaps.[6] Activists may also question whether boards are sufficiently independent.[7]

Adding new skills for future strategy

Lead directors said that a board must collectively have all the skills necessary to oversee the company's strategic future. One lead director said, *"When we add a new director, we look at the strategy and then use that to define what we need."* Many boards maintain a matrix that tracks diversity in director expertise and helps identify gaps for the board to fill. Lead directors cautioned, however, that as boards assess skills,

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[3] Adam Satariano, "Apple Facing Criticism About Diversity Changes Bylaws," *Bloomberg*, January 6, 2014.

[4] Adam Satariano, "Apple's Campbell Retires From Board; Sue Wagner to Join," *Bloomberg,* July 18, 2014.

[5] EY Center for Board Matters, *Let's Talk: Governance: 2014 Proxy Season Review* (New York: Ernst & Young LLP, 2014), 2.

[6] Joann S. Lublin, "Field Experience Helps Win Board Seats," *Wall Street Journal,* September 23, 2014.

[7] Joann S. Lublin, "For Older Board Members, the Pressure to Move On," *Wall Street Journal,* December 23, 2014.

they should focus on long-term needs: *"Make sure what you get is long lasting. Expertise can become stale."*

Some critics see a lack of corporate directors who are true subject matter experts. They say many board seats are filled by corporate generalists who are less willing to make difficult decisions because they give too much deference to management.[8] In recent years, however, boards have added more directors who lack prior board experience but have held functional leadership roles in areas like technology, corporate strategy, and human resources.[9] Lead directors discussed the benefits of having such experts on a board. One said, *"It is comforting for me to see our technology-expert board member listen to our chief technology officer's presentations and ask questions that I'm less capable of asking."*

Some lead directors challenged the presumption that the best boards are those filled with experts. One asserted, *"I have an aversion to functional experts on boards. Everyone defers to that person, even though we are all responsible. The skills that we should look for are judgment, knowledge, and pattern recognition."* Another explained, *"The ability to fit in and be valued on a corporate board is incredibly important and not as obvious. With some experts, their world moves so fast, and the corporate world often doesn't. That creates a misalignment on patience and risk."*

Recognizing that, as one member said, *"we want to see everything in each new director but can't have everything,"* members discussed some of the most important backgrounds and skills that their boards have targeted:

- **Digital and consumer-facing technology.** As more companies derive revenue online, companies are focused on recruiting directors with digital experience. One member said, *"It is important to find someone who understands the way we interface with consumers and how we use social media."* However, others raised concerns about directors who fit this profile: *"We added someone who was a good director but who was really busy with a career in this field, and that created issues."* Another said, *"We wanted to add a digital director but faced a dilemma: Most digital experts were not interested in or qualified to sit on a board for all the other issues we address."* One member described a company that addressed these concerns by creating advisory groups representative of the company's customer base that report directly to the board.
- **Cybersecurity and information technology.** Separate from digital experience, companies are adding directors with broader technology experience or information security experience. One member said, *"Given the importance of [information technology], we added a director who is the former head of [a software company]. We needed to better understand all the technology spending. [This director] has experienced these issues several times and helps us to figure out the right questions."* Others, however, felt that they could gain expertise without adding a technologist to the board. They noted that in this area in particular, expertise quickly becomes outdated for directors who are no longer working in the field full time. One lead director stressed, *"For cybersecurity, we want someone*

[8] Dominic Barton and Mark Wiseman, "Where Boards Fall Short," *Harvard Business Review,* January-February 2015.
[9] Spencer Stuart, *Board Index 2014* (Chicago: Spencer Stuart, 2014), 11-12.

working on that 24/7. That means adding to management." Others suggested having cybersecurity experts periodically present to the board or key committees.

- **Industry.** Members said it is important to have directors with management experience in the same or an adjacent industry. One member said, *"It is helpful to have people who can interface with research and development and are able to explain things to the rest of the board."* Another said industry experience helps with more than just oversight: *"It is not just about asking a 'gotcha' question, but providing support to the executive team. It is important to have directors with skills that help the CEO address specific weaknesses."*
- **Investment community.** Boards are adding more directors with experience as an investor. For example, one member noted that eBay added former Wellington Management CEO Perry Traquina to its board earlier this year.[10] Another member explained, *"Investors like to see people who know what it is like to be an owner. It is a good response to the activist pitch that 'boards have no idea how we think.'"*
- **International.** Adding directors with international experience is also a priority for LDN members. Likewise, 55% of respondents in the 2014 Spencer Stuart governance survey placed international expertise on their wish list for new directors.[11] One member observed of a particular board, *"We are all from the US, but the majority of our business is in Europe and Asia. That doesn't make sense."* However, members said that logistical challenges involving travel for meetings and time zones for telephone conferences make maintaining a multinational board difficult. One solution that members proposed is adding a director with recent international experience who now lives in the United States.

Creating a more diverse boardroom

Lead directors observed that diversity helps boards spot problems and craft creative solutions. Every respondent to PwC's 2014 investor survey said that boards should be discussing ethnic and gender diversity.[12] Likewise, the majority of the investors and issuers who participated in Institutional Shareholder Services' 2014 policy survey said they consider diversity when evaluating boards.[13] One lead director said, *"If you make up your mind that you are going to add diversity to the board, you will get good results."*

Pressure is mounting to alter board composition in the following areas:

- **Gender.** A number of groups are working to pressure companies to add more female directors and to help them identify qualified candidates.[14] LDN members said that they have made closing board gender gaps a priority. Furthermore, the move toward gender equity seems to pay off for investors: A

[10] Tess Stynes and Maria Armental, "EBay Names 2 New Directors to Its Board," *Wall Street Journal*, March 23, 2015.

[11] Spencer Stuart, *Board Index 2014*, 13.

[12] PwC, *What Matters in the Boardroom? Director and Investor Views on Trends Shaping Governance and the Board of the Future* (PricewaterhouseCoopers, 2014), 10.

[13] Institutional Shareholder Services, *2014-2105 Policy Survey Summary of Results* (Institutional Shareholder Services, 2014), 6.

[14] For example, the Thirty Percent Coalition seeks to have women hold 30% of US board seats by the end of 2015. See "Increase the Pace of Gender Diversity in the Boardroom," Thirty Percent Coalition, accessed April 9, 2015.

2011 study found that Fortune 500 companies with the most women directors outperformed those with the fewest, and those with sustained high female representation (three or more women) performed better than those with sustained low representation.[15]

- **Race and ethnicity.** Lead directors said that their companies are also committed to increasing racial and ethnic diversity on their boards. Before the meeting, one member said, *"We have such a diverse customer base, and we need to more and more look like the people that we are serving."*
- **Age.** One consideration as boards look to expand their collective skill set is youth. In the past decade, the average age of an independent director on an S&P 500 board has crept up from 60.5 to 63.1 years, and retirement ages have also risen.[16] Some members think that younger directors bring a unique and valuable perspective that should be represented in the boardroom: *"Digital experts are usually in their 20s and 30s. If we want to drive a revenue stream online, we need younger people in the boardroom and in top management."*

Members explained that it takes a conscious, committed effort to add diversity to the board: *"People are comfortable with people like them, so you have to say adding diversity is mandatory."* Others cautioned that diversity cannot be the only purpose for adding someone to a board: *"Don't do the disservice of creating a mindset that diversity is the only reason someone is on the board. Each new director is on the board for a variety of reasons."*

Director selection

The search for new directors is a process that requires regular assessment of the board's needs and periodic analysis of when to add a new director. One member said, *"We should always be looking and networking. Too often people don't think we have an opening, but the search needs to be ongoing."* Board members, key leaders from management, and outside advisers generally participate in director selection.

Expanding the board

Many boards add directors to the existing roster by expanding board size. However, lead directors said that boards should determine their optimal size. Of S&P 500 companies' boards, 9% have eight or fewer directors , 74% have nine to 12 directors, and only 17% have 13 or more directors.[17] Lead directors expressed a preference for a board that is small enough to develop relationships but large enough to handle the workload.

One member identified a challenge to having a small board at a large, global company: *"My favorite number is nine directors, but it is hard to keep a board that small and appropriately staff all of the committees."* Increasing the size of the board has the benefit of adding new perspectives without losing

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[15] Meta Wagner, "Does the US Need Quotas to Boost Parity in the Boardroom?" *Boston Globe*, April 5, 2015.

[16] Spencer Stuart, *Board Index 2014*, 8–9.

[17] Ibid., 14.

the experience of long-tenured directors. However, members acknowledged that if a board gets too big, problems can arise. One said, *"We want to be able to get everyone engaged. That is not possible with a really big board."*

At many companies, the size of the board is not constant. It is common for there to be some overlap between arriving and departing directors. Lead directors said that flexibility is particularly important when a board is replacing a director with specialized experience or who chairs a particular committee. One member said, *"In certain cases, we like to have one year of overlap where the new and departing director serve together. We don't want an experience gap."*

Recruiting new directors

Once a board decides to add a new member, it conducts a collaborative search process where several participants play key roles:

- **Lead director.** Lead directors play a central role in recruiting new directors. One said, *"I lead the process along with the chair of the nominating committee. That includes actively identifying prospects and interviewing candidates."* In addition, members said that the lead director usually coordinates with senior management, asking for input and providing periodic updates.
- **CEO and senior management.** Boards also rely on their CEOs and other senior managers to interview and assess new directors. Members made clear, however, that it is the board – not management – that recommends the appointment of new directors to shareholders. One member said, *"We want to make sure a new director gets along with the CEO before joining the board, but the CEO doesn't have a controlling vote."*
- **Search firms.** Lead directors said that their boards do use search firms to identify candidates. They advised that the firms be given detailed instruction and receive close oversight. One lead director said, *"Search firm clients get what they deserve. If you provide a detailed specification, the good firms will bring back good candidates. But you need to make it clear that you won't put up with the stock list."* Several lead directors said that search firms can be helpful in identifying diverse candidates that a board might not identify itself (see "Adding diversity," below). Companies also use search firms to conduct background or reference checks on nominees.

Members observed that the recruiting process is a two-way street. One explained, *"We interview them and they interview us. We need to make it comfortable."* For some, that means appointing a small selection team to avoid overburdening candidates. One said, *"The lead director and CEO do the interviews, and we bring two other directors based on the skills we are looking for."* Another added, *"I wouldn't join a board where I had to meet every director. It would be intimidating and I would be concerned that the board had factions."* Other members prefer having finalists meet the whole board so new directors can hit the ground running. One member said, *"Meeting everyone is an extraordinary way to get insight into the board. There are ways to do it that are not burdensome or scary."*

Adding diversity

Some members said that their companies ask search firms to provide lists of prospective directors that include only candidates of a particular race or gender. One member said, *"We asked the headhunter to deliver us a slate of candidates with two specifications: female with an IT background. We got plenty of great candidates."* Another added, *"The talent is out there. I reject the proposition that there are not diverse candidates who have the skills we need and can bring added value. We need the courage to say it is unacceptable when we prioritize diversity then get a list with only one or two diverse candidates."* Others made clear, however, that narrowing candidates at the outset is not always necessary. One said, *"We don't need to make strict rules ahead of time. We accommodate based on past results. If every time we picked a non-diverse candidate, then qualify the search. But if not, there is no need to adjust the process."*

One challenge that comes with adding new directors with different skills or experience is the increased likelihood of adding a first-time corporate director. One member declared, *"We need to find ways to bring on people who don't have the experience but can grow into these roles."* Another described a situation where frustrations with search firms led a company to *"turn things upside down and take a different approach."* In that case, the company added an academic without corporate experience who became a *"brilliant director."* Members discussed creating mentoring programs to help ease the transition. One lead director said, *"We were all first-time directors once, too. There is a lot we can share."* Another explained, *"With a new director, there is a chance for immediate counseling. It can be hard because a boardroom is a group of peers, but don't resist the opportunity to be a tutor."*

Assessment and turnover

Even with a 26% increase in new independent directors at S&P 500 companies in the last two years, boards are adding new directors far less frequently than they did a decade ago.[18] During the same period that turnover has slowed, board size has remained stable. [19] A recent study found that companies that replaced three or four directors over a three-year period outperformed both peers who made no changes and those who made more changes, suggesting an optimal rate of turnover.[20] Though this does not prove that new directors improve performance, the correlation puts board refreshment on investors' radar in a bigger way. Faced with increased scrutiny, members said that their boards are taking a more thoughtful approach to director tenure and ways to ensure directors continue to provide meaningful contributions.

Age limits and tenure

The most common way that boards ensure refreshment is through setting a mandatory retirement age. Over the past decade, the number of S&P 500 boards with a mandatory retirement age has remained stable

[18] Spencer Stuart, *Board Index 2014*, 4.

[19] Ibid., 8.

[20] George M. Anderson and David Chun, "How Much Board Turnover Is Best?" *Harvard Business Review,* April 2014.

at around 75%; however, the number of boards that set the age at 75 or older has risen from 5% to 30%.[21] Most members said that they favor some mechanism for refreshing the board but believed there are more thoughtful approaches than strict age limits. One said, *"We all think renewal is a good idea until a good director is on the retirement list."*

Term limits provide another mechanism for refreshing the board, but only 3% of S&P 500 companies explicitly include a director term limit in their corporate governance guidelines.[22] Directors may also informally agree that they will only serve for a specified term.[23] One member favored term limits as a concept: *"Term limits provide a more elegant exit than age limits. They give enough time for someone to make a contribution, then create space for someone else's contribution."* Other members favored limits for board or committee chairs but were less open to limits on overall board service: *"You should look at the board dynamics, not just the numbers. Are pockets of power emerging?"*

Average board tenure is also being considered as a criterion for board refreshment, particularly among investors. State Street Global Advisors recently adopted a policy of assessing a company's average board tenure, with an option to vote against directors if that average is longer than the average market tenure and other governance deficiencies are identified.[24] (Among S&P 500 companies, the average director tenure is 8.4 years.[25]) Members said that the best boards have a good mix of longer-tenured directors with intimate knowledge of the company and newer directors with different perspectives. As a result, many were open to using average tenure as a benchmark for board refreshment, though they were concerned that this approach could become too formulaic.

Evaluations and terminations

Nearly every public company conducts some form of annual self-evaluation. While most directors believe their boards' self-evaluations have become more effective over time, most directors also say that it is difficult to be frank in these evaluations.[26]

One way to deal with this difficulty is to have external firms conduct the evaluation, a practice that is expected to become more common in future years.[27] Many investors favor third-party board assessments.[28] However, lead directors gave third-party evaluations mixed reviews. One said, *"Outsiders provide some benefit, but you can't rely solely on external parties. The outsiders couldn't get a deep enough understanding of the board for us, so now we do our own annual reviews but bring them in every three*

[21] Spencer Stuart, *Board Index 2014*, 9.

[22] Ibid., 4.

[23] Joann S. Lublin, "For Older Board Members, the Pressure to Move On."

[24] Rakhi Kumar, *Addressing the Need for Board Refreshment and Director Succession in Investee Companies* (State Street Corporation, February 2015), 2-3.

[25] Spencer Stuart, *Board Index 2014*, 5.

[26] PwC, *Trends Shaping Governance and the Board of the Future: PwC's 2014 Annual Corporate Directors Survey* (PricewaterhouseCoopers, 2014), 22.

[27] Joann Lublin, "'Board Doctors' Help Supervise the Supervisors," *Wall Street Journal*, February 17, 2015.

[28] EY Center for Board Matters, *2014 Proxy Season Review*, 3.

years for a check." This approach is consistent with the United Kingdom's corporate governance code recommendation that evaluations be conducted by an external facilitator at least triennially.[29]

While evaluations have historically focused on the performance of the board or its committees as a whole, members said that more of their boards are evaluating directors individually. In 2014, 34% of S&P 500 companies conducted individual director evaluations, up from 17% in 2009.[30] One member explained, *"When someone is not pulling their weight, it is easier to relay that message when it is informed by the perspective that all the other directors shared in a review."* Another added, *"If you want someone to improve, you need to deliver the feedback one-on-one, face-to-face."*

When a director underperforms, it falls on the other directors to take action. In some cases, providing more direct feedback and coaching is not enough and the director needs to be removed. One member explained, *"The board needs to have the willpower to remove underperformers. Getting rid of the problems also raises the game of the remaining directors."* Despite the acknowledged benefits of removing underperforming board members, more than half of the directors surveyed by PwC said there are impediments to removing underperformers.[31] Lead directors discussed some of these challenges. One said, *"It is really hard to say someone isn't up to snuff. A lot of this is empirical and based on individual judgment."*

It is uncommon for companies to communicate with investors about board refreshment. According to a recent report by the Council of Institutional Investors, most US companies only disclose the fact that the board has an evaluation process, without elaborating on that process. The report said that some investors are eager for more information: "Disclosure is an indication that a board is willing to think critically about its own performance on a regular basis and tackle any weaknesses."[32] Similarly, almost all director terminations occur informally and discreetly, without a press release or other communication to inform investors and other stakeholders about the board's decision.

Lead directors acknowledged the disconnect between the board's process and investors' impressions. One said, *"Investors don't realize how much work we do. They are usually shocked when they join a board and realize we are not as irresponsible as they think we are."* Yet members hesitated to embrace increased disclosure about the inner workings of the board. One explained, *"We won't disclose more, because it is discoverable in litigation."*

Conclusion

External pressure on board composition forces directors to think harder about the background and skills it takes to fill a board vacancy. Boards are considering a broader pool of director talent, thereby adding new, valued perspectives. Boards are also improving their performance by removing directors who add less

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[29] Financial Reporting Council, *The UK Corporate Governance Code* (London: Financial Reporting Council, 2012), 16.

[30] Spencer Stuart, *Board Index 2014*, 5.

[31] PwC, *Trends Shaping Governance and the Board of the Future: PwC's 2014 Annual Corporate Directors Survey*, 6.

[32] Council of Institutional Investors, *Best Disclosure: Board Evaluation* (Washington, DC: Council of Institutional Investors, 2014), 2.

value. The cumulative effect of these changes should be a refreshed board, better equipped to face the company's strategic challenges and capitalize on new opportunities.

About this document

The Lead Director Network (LDN) is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairs drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

Appendix: Network participants

The following network members participated in all or part of the meeting:

- Dick Auchinleck, Lead Director, ConocoPhillips
- Jack Brennan, Lead Director, General Electric Company
- Dan Carp, Non-Executive Chair, Delta Air Lines
- Loren Carroll, Non-Executive Chair, KBR
- Sandy Cloud, Lead Trustee, Eversource Energy
- Don Felsinger, Lead Director, Archer Daniels Midland and Northrop Grumman
- Ann Maynard Gray, Non-Executive Chair, Duke Energy
- Ann Hackett, Lead Director, Capital One Financial
- Phil Humann, Presiding Director, Coca-Cola Enterprises, Equifax; Lead Director, Haverty Furniture
- Linda Fayne Levinson, Non-Executive Chair, Hertz
- Ellen Marram, Lead Director, Eli Lilly; Presiding Director, Ford
- Steve Miller, Non-Executive Chair, AIG
- Ed Rust, Presiding Director, Caterpillar; Lead Director, McGraw-Hill Financial
- Tom Wajnert, Non-Executive Chair, Reynolds American

The following network members took part in pre-meeting discussions:

- Peter Browning, Lead Director, Acuity Brands
- Wes von Schack, Lead Director, Bank of New York Mellon and Edwards Lifesciences
- Dan Schulman, Non-Executive Chair, Symantec

The following King & Spalding attorneys participated in all or part of the meeting:

- Gary Grindler, Partner; Special Matters and Government Investigations Practice Group
- Dixie Johnson, Partner; Special Matters and Government Investigations Practice Group
- Grant Nakayama, Partner; Tort and Environmental Practice Group
- Cal Smith, Partner; Corporate Practice Group
- Michael Smith, Partner; Co-Chair, Securities Litigation Practice Group
- Chris Wray, Partner; Chair, Special Matters and Government Investigations Practice Group