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# BOARD COMPOSITION, DIVERSITY AND REFRESHMENT

In her regular column on corporate governance issues, Holly Gregory explores the challenges that boards and their corporate governance and nominating committees face when making decisions relating to the composition of the board.

Board composition provides the starting point for establishing a strong and effective board. In the past decade, significantly greater attention has been given to the composition of public company boards and the role of independent corporate governance and nominating committees in determining board composition. This has been driven in part by Securities and Exchange Commission (SEC) regulations and stock exchange listing rules, as well as by shareholder expectations. The increased reliance on independent corporate governance and nominating committees is due to concerns about board nomination processes and procedures and management's influence on governance decisions.

While delegating key board composition decisions to an independent board committee has proven effective in reducing undue management influence, difficult challenges remain concerning the ability of the board to refresh its composition. This article explores:

- The role of the independent corporate governance and nominating committee in making decisions relating to board composition.
- The relationship between board turnover and changes in the company's strategic needs and in the business environment.
- The impact of board diversity, including recent data examining the positive relationship between a diverse board and company performance.
- The importance of board refreshment mechanisms, including limits on board service.

## ROLE OF THE CORPORATE GOVERNANCE AND NOMINATING COMMITTEE

The importance and mandate of the corporate governance and nominating committee has grown significantly over the past decade. Stock exchange listing rules, SEC regulations, shareholder demands and best practice literature have emphasized the critical impact of board composition and other corporate governance decisions on the ability of the board to function effectively. For example:

- Stock exchange listing rules require that independent directors play key roles in nomination and re-nomination decisions.

## KEY TIPS FOR BOARD SUCCESSION PLANNING

- **Create a matrix.** Define the matrix of experience, expertise and perspective that needs to be represented on the board and reassess it periodically, in line with the changing business environment and evolving company strategies. Consider whether the board has the understanding, expertise and experience needed to direct the company given these changes.
- **Make a wish list.** Periodically (for example, annually) consider what the next several director nominees should bring to the table. Prepare a wish list of qualities that could strengthen the board over the next several years.
- **Ensure a variety of qualities are represented.** Avoid the natural tendency to over-value qualities that are very similar to those reflected in current directors.
- **Assess directors rigorously.** Assess individual directors when determining whether to re-nominate, and do so with some rigor. Determine if there is a match between the experience, expertise and perspective of each director and the board's needs, as defined in the matrix described above. Consider whether the director's experience and expertise are still relevant and up to date and whether the director is a strong contributor.
- **Avoid automatic re-nomination.** Avoid the trap of automatic re-nomination due to the difficulty inherent in asking a director to leave.
- **Conduct a broad search.** When undertaking a search, look at a broad range of director candidates. Insist that both gender and racial diversity are always represented in any slate of potential candidates for consideration.
- **Avoid favoritism.** Do not give undue emphasis to potential candidates known by current directors or the CEO.

- The SEC has amended disclosure rules to require more information in the proxy statement about director qualifications, and has reinterpreted proxy rules to allow shareholder proposals that seek shareholder access to the company's proxy materials for the nomination of directors.
- Shareholders have pushed successfully for more influence on board composition decisions through efforts to replace plurality voting with majority voting standards and through negative vote campaigns that target individual directors.

>> For more information on the director qualifications disclosure required to be included in the proxy statement, search Proxy Statements on our website.

As independent corporate governance and nominating committees seek to recruit and retain directors with the necessary expertise and objectivity to provide high-quality oversight, they are often assisted by professional search firms and other advisors in assessing board needs and finding appropriate candidates. As a result, the influence of the CEO on director selection has been reduced. However, boards continue to find it difficult to refresh themselves, and a key challenge for the corporate governance and nominating committee is to ensure that the board is not unduly entrenched.

>> For a model charter for the nominating and corporate governance committee of the board of a public company, with explanatory notes and drafting tips, search Nominating and Corporate Governance Committee Charter on our website.

## BOARD TURNOVER AND BUSINESS NEEDS

The rapid pace of change in the business environment and increasing expectations imposed on public company boards underscore the need for corporate governance and nominating committees to continually assess whether the composition of the board is appropriate for the evolving complexity of the business. Board composition should relate to the company's strategic needs, which change as a company and its business environment evolve. Corporate governance and nominating committee efforts need to focus on nominating and retaining those directors that together reflect the mix of skills, experiences, backgrounds and independence that will best position the board for effective decision-making relating to the business.

Boards also need to balance interests in continuity with the need for fresh perspectives and diversity that board composition changes can bring. Recent data suggests that corporate governance and nominating committees may be overweighting the value of continuity on the board, leading to concerns about board entrenchment. According to a study by Spencer Stuart (Spencer Stuart Study), *The 2012 Spencer Stuart Board Index* (available at *spencerstuart.com*), director turnover has slowed considerably in the past ten years, from 401 new directors in the S&P 500 in 2002 to only 291 new directors in 2012, a drop of 27% and the smallest number of new directors in a decade.

The reduction in turnover of public company boards is associated with a rise in director age. Approximately 40% of directors are now 68 years old or older. The average age limit set in board policies is now 72 years old and a number of boards have increased the age limit to 75 years old. Directors have postponed retiring due to health and longevity improvements generally, and due to the economic downturn that impacted retirement savings.

## BOARD DIVERSITY

Slow director turnover has the potential to reduce the ability of boards to meet evolving needs. It also reduces the diversity of experience and viewpoints in the boardroom by impeding the representation of women and racial minorities, to the potential detriment of the board.

### DIVERSITY AND PERFORMANCE

A growing body of research indicates that bringing together individuals with different backgrounds, skills and perspectives provides a performance advantage, with diverse groups out-performing homogenous groups, including in business settings. Board diversity is believed to be associated with innovation and with attracting and retaining employees. For example:

- According to a study by the Credit Suisse Research Institute, *Gender Diversity and Corporate Performance* (available at *infocus.credit-suisse.com*), companies with one or more women directors had higher net income growth over a six-year period than companies that had no women on the board. The study examined 2,400 companies from around the globe and found average net income growth of 14% and 10%, respectively, for the two groups of companies.
- A study by David A. Carter, Betty J. Simpkins and W. Gary Simpson, *Corporate Governance, Board Diversity, and Firm Value* (see *Financial Review, Volume 38, Issue 1, February 2003*), examined the relationship between board diversity and firm value for Fortune 1000 firms. The study found a significant positive relationship between the percentage of women or minorities on the board and firm value.
- According to a recent report by the Committee for Economic Development (CED), *Fulfilling the Promise: How More Women on Corporate Boards Would Make America and American Companies More Competitive* (available at *ced.org*), women directors help deliver measurable business gains and may be the key differentiator in future global success.

### BOARD DIVERSITY STATISTICS

While it is generally recognized that the expression of diverse viewpoints and perspectives in the boardroom is associated with improved decision-making, the boards of S&P 500 companies continue to be relatively homogenous. Statistics show that board diversity is growing at a glacial pace. The percentage of women directors is growing at just one-half of a percentage point per year, and racial diversity is growing at a slower rate. For example:

- According to the Spencer Stuart Study:
  - only 17% of S&P 500 directors are women, a very modest gain from 12% in 2002;
  - less than 13% of S&P 500 board seats are filled by racially diverse directors and the proportion of diverse directors is even lower in Russell 3000 companies; and
  - while 91% of S&P 500 boards have one female director, only 61% have two or more women on the board, and only 20% have three or more women on the board.
- According to a report by Ernst & Young, *Getting on Board, Women Join Boards at Higher Rates, Though Progress Comes Slowly* (available at *ey.com*), fewer than 6% of independent board leaders (independent chairs or lead directors) are women.

Additionally, US boards are now lagging behind European boards where diversification has been made a priority through government regulation and pressure. Women are now represented in greater numbers on the boards of European companies than in US companies. According to the Spencer Stuart Study, "[t]he S&P 500 now trails Norway (40%), Finland (27%), Sweden (26%), France (22%), Denmark (18%) and the Netherlands (18%) and ties with Germany (17%) in the percentage of women on corporate boards."

## BOARD REFRESHMENT MECHANISMS

Re-nomination decisions present challenges due to the natural reticence to disturb the status quo of the board absent a significant issue of director underperformance. Yet the business environment is continually changing and the composition of the board needs to stay relevant to the business. Boards need to thoroughly analyze their compositional needs and evaluate individual directors to inform re-nomination decisions.

Unfortunately, most corporate governance and nominating committees are not yet rigorously assessing directors. Notwithstanding the fact that most directors stand for election and must be re-nominated on an annual basis, the unspoken assumption is that directors will continue to serve until they no longer wish to or until they reach an age or term limit imposed by the board (and age and term limits are often subject to modification or waiver). The overall result is fewer director searches and fewer opportunities for new perspectives and experiences to be represented on the board.

## THE SEC'S APPROACH TO BOARD DIVERSITY

In 2009, the SEC amended Item 407(c)(2)(vi) of Regulation S-K to require, effective February 28, 2010, disclosure of:

> "whether, and if so how, the nominating committee (or the board) considers diversity in identifying nominees for director. If the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees, describe how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of its policy."

The definition of diversity was left for each board to determine. The SEC indicated that diversity could mean different viewpoints, professional experience, education, skill, race, gender, national origin and other qualities (see *Proxy Disclosure Enhancements, Release Nos. 33-9089 and 34-61175 (December 16, 2009)*).

The rules do not require companies to have a policy in place, but they do require companies that have a policy to disclose how the policy is implemented and how the nominating committee evaluates the policy's effectiveness. This may have had the unintended consequence of encouraging companies that might otherwise have adopted a board diversity policy to avoid doing so.

Boards should be sensitive to board composition needs and diversity concerns, and consider whether board culture and processes provide sufficiently for change. Along with considering the company's strategic direction when evaluating board composition, boards should assess individual director capacity and contributions annually.

### LIMITS ON BOARD SERVICE

Where boards find it difficult to apply rigor in connection with board re-nomination decisions due to board culture, boards should explore adopting limits on board service. Age and term limits pose concerns in that they allow some directors to serve longer than they should by setting an expected length of service at the outer limits, while also causing excellent directors to be forced off of the board when they may still have plenty to contribute. This latter issue causes most boards to make exceptions to age and term limits, and those exceptions then become the rule.

Age limits have been rising and term limits are not well accepted. According to the Spencer Stuart Study, while approximately 75% of S&P 500 boards set a mandatory retirement age for directors (up from 55% in 2002), the average age limit has risen to 72 years old. 22% of S&P 500 companies set the age limit at 75 years old or older, versus just 2% in 2002.

Strict age or term limits are arbitrary in two directions: they can result in excellent directors being forced to leave and they can cause mediocre directors to stay on longer than their contributions might indicate they should. Indeed, age and term limits often express an expectation that a director's tenure will last until the limit.

Regular, rigorous individual director evaluations in connection with re-nomination decisions are preferable. However, boards that prefer implementing limits could borrow a tactic from the UK and consider an "independence term limit," where after nine to 12 years of service, a director would no longer qualify as independent. A truly valuable director could remain on the board, but his continued service would impact the board's independence ratio. This would cause the board not to extend the director's service without very good reason. (The independence term limit is an adaptation of the UK rule that independent directors are limited to nine years in that role.)

>> For more information on limits on board service, search Corporate Governance Practices: Commentary on our website.

### SHAREHOLDER ACTION

Unless corporate governance and nominating committees address the issue of board succession planning in a more rigorous manner, boards may start to see greater activity from shareholders who believe that improved board turnover and diversity is beneficial. Shareholders may use tools that have proven powerful in addressing other issues. For example, they may:

- Mount campaigns to vote against members of corporate governance and nominating committees at companies that have very little board turnover or do not have gender and racial diversity on the board.
- Implement shareholder proposals seeking enhanced board turnover mechanisms.
- Target boards they view as intractable with proxy access proposals, on the theory that shareholders need an ability to nominate directors where the board appears entrenched or lacks diversity.

*The views stated above are solely attributable to Ms. Gregory and do not reflect the views of Weil, Gotshal & Manges LLP or its clients.*