

Director

Dialogue

S E R I E S

# Board Composition

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## Introduction

Several factors have combined to make board composition a priority for a growing number of public companies. According to recent NACD survey results, the rate of director turnover on public-company boards has been on the rise over the past several years—nearly doubling since the financial crisis.<sup>1</sup> Calls for greater boardroom diversity, such as that from Securities and Exchange Commission (SEC) Chairman Mary Jo White in a recent speech,<sup>2</sup> have become a common theme in the corporate community. Additionally, investors across the spectrum have developed a keen interest in board composition and director skill sets. During the first quarter of 2014 alone, 34 activist campaigns resulted in a gain of board seats by the activist, up from 19 in the first quarter of 2013.<sup>3</sup> As one major institutional shareholder told NACD, “The world is changing—we want to understand what boards are actually doing to respond. What capabilities [do companies] need to be successful, and how are [they] building those [capabilities] on the board?”<sup>4</sup>

NACD and McGladrey held a series of roundtable meetings in 2014 that brought together more than 40 directors to discuss issues and challenges related to board composition. Their dialogue focused on four questions:

- What baseline skills and characteristics are most important for directors?
- When do boards consider the need for specialized skills?
- How can directors think strategically about board composition?
- How can directors effectively communicate to investors about the makeup of their boards?

### Trends in Board Composition and Evaluation

- Nearly two-thirds (approximately 64%) of boards have replaced at least one director since March 2013, according to the latest NACD Public Company Governance Survey. The proportion of boards that added or replaced at least two directors has risen over the past seven years from 17.5% in 2007 to just over 31% in 2014.<sup>5</sup>
- A majority of directors (approximately 60%) report that their boards look one-to-three years into the future when considering director recruitment; but for 18% of NACD survey respondents, the board’s time horizon for director recruitment is one year or less.<sup>6</sup>
- Among NACD survey respondents, 87.2% conduct full-board evaluations; 76.9% conduct evaluations at the committee-level; and 42% conduct individual director evaluations.<sup>7</sup>
- In a survey of global public-company directors, Heidrick & Struggles found that 63% of boards change committee composition “every few years,” while 27% change committee composition “rarely.”<sup>8</sup>

<sup>1</sup> National Association of Corporate Directors (NACD), *2014–2015 NACD Public Company Governance Survey* (Washington, DC: NACD, 2014) [hereafter cited as *2014–2015 NACD Public Company Governance Survey*], <http://www.nacdonline.org/PublicSurvey>.

<sup>2</sup> Yin Wilczek, “SEC Chairman Calls on Companies, Shareholders to Help Increase Number of Women Directors,” *Bloomberg BNA*, Sept. 19, 2014.

<sup>3</sup> William L. Watts, “Activists Here to Stay as War Chests Near \$100 Billion,” *MarketWatch*, Apr. 5, 2014, <http://www.marketwatch.com/story/invest-like-icahn-the-rise-of-the-activist-investor-2014-04-02>.

<sup>4</sup> NACD, *Investor Perspectives: Critical Issues for Board Focus in 2014* (Washington, DC: NACD, 2014), <http://www.nacdonline.org/Resources/Article.cfm?ItemNumber=9850>.

<sup>5</sup> NACD, *2014–2015 NACD Public Company Governance Survey*.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> Bonnie Gwin and Susan Stautberg, *The State of Leadership Succession Planning Today* (Chicago: Heidrick & Struggles International, 2014).

## What Baseline Skills and Characteristics Are Most Important for Directors?

Participants in the roundtable discussions agreed that the fundamental characteristics of a successful board member—including independence, business expertise, willingness to express disagreement in a constructive way, and the ability to commit time and energy to the role—have remained relatively consistent over time (see the “Personal Characteristics of Directors” sidebar below). In addition, roundtable attendees proposed three other skills that distinguish high-performing directors:

- **An ability to effectively challenge management:** *“It’s more than the ability to ask good questions. It’s having the judgment to tell whether management’s answer is sound or if the board needs to probe further—and in the latter case, the willingness to keep asking until we’re satisfied with the answer.”*<sup>9</sup>
- **An ability to put issues into the appropriate context:** *“Sometimes the board has to operate at the 10,000-foot level, and at other times we might need to drop down into more detail but without micromanaging. Good directors can fit issues into the right context.”*
- **Intellectual curiosity:** *“When directors demonstrate a dynamic sense of curiosity, board productivity is likely to be high.”*

### Personal Characteristics of Directors<sup>10</sup>

- Integrity and accountability
- Informed judgment
- Financial literacy
- Mature confidence
- High performance standards
- Independence
- Competency in one or more core domains, such as accounting and finance, industry expertise, management and leadership, crisis response, international markets, business strategy, etc.
- Willingness to commit time and effort to the role
- Willingness to maintain current knowledge in specific areas of expertise, about general issues affecting the company, and about the roles and responsibilities of directors

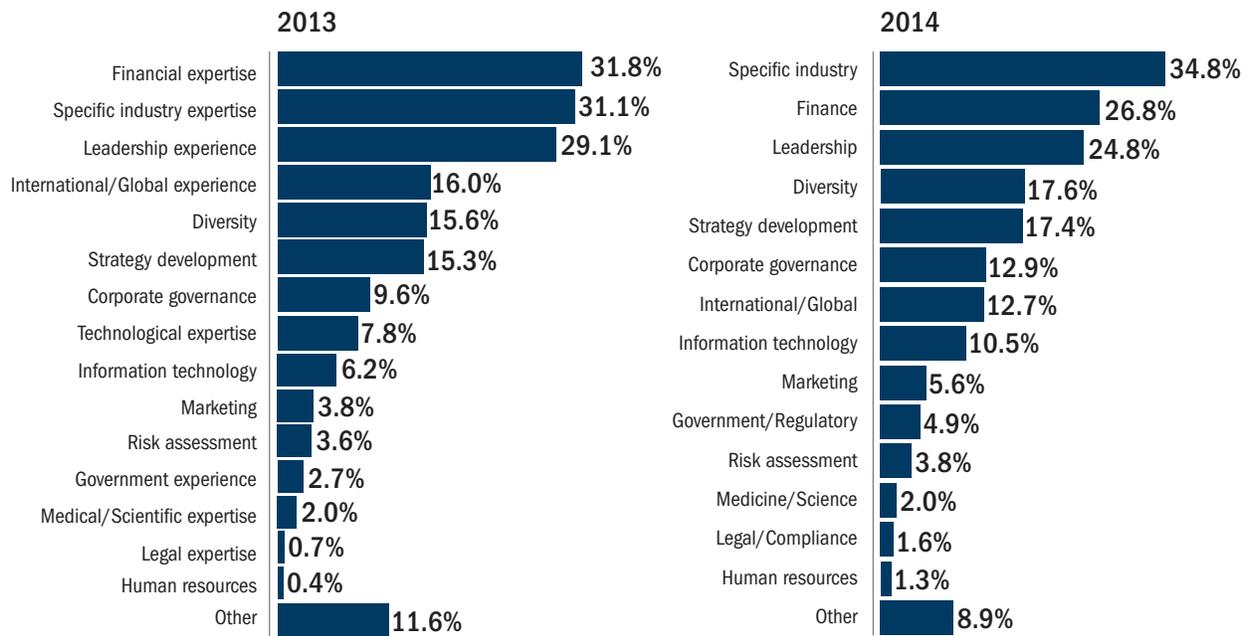
<sup>9</sup> Roundtable discussions were conducted under the Chatham House Rule. Italicized quotations are from director-participants.

<sup>10</sup> NACD, *Report of the NACD Blue Ribbon Commission on Director Professionalism* (Washington, DC: NACD, 2011), 7–10, <http://www.nacdonline.org/Store/ProductDetail.cfm?ItemNumber=3721>.

## When Do Boards Consider the Need for Specialized Skills?

For the past two years, expertise in a company’s specific industry, financial expertise, and leadership experience have topped the list of attributes that boards are seeking in new directors, according to NACD survey respondents.<sup>11</sup>

### What types of experience were most important for director recruitment over the past two years?



Attendees at the roundtables identified several other circumstances in which having directors with specialized skills can be advantageous:

- Regulated industries:** “We’ve found it helpful to have a couple of board members with experience in the policy and regulatory arenas. Management often has a knee-jerk reaction to fight regulations at every turn—the board can provide guidance on how to work constructively with regulators.”
- Early-stage/high-growth companies:** “In emerging growth companies, the priority is topline growth; so having deep sales and marketing experience [on the board] is valuable. More generally we’re looking for directors who have made that journey and successfully taken companies from small- to large-scale.”
- Transactions:** “Companies that are heavily acquisitive, or that will be going through a phase of structural changes, can benefit tremendously from directors’ personal experience. On one of my boards we’re looking for one or two directors who have been through spin-offs.”
- Small-cap companies:** “The breadth of management experience differs significantly between small and large companies—the bench is less deep. So the board may need to provide more advice and mentorship in a small-cap environment, where the board itself is likely to be smaller and management is more resource-constrained.”

<sup>11</sup> NACD, 2014–2015 NACD Public Company Governance Survey; NACD, 2013–2014 NACD Public Company Governance Survey (Washington, DC: 2013).

Phyllis Deiso, partner and national SEC practice leader at McGladrey, commented, “While it is desirable to have alignment between board skills and company strategy, perhaps what is more important is the ability of a board to reevaluate and transform itself as a company’s strategic direction evolves.”

Some directors are beginning to ask questions about whether their boards should recruit new members with experience in cybersecurity, emerging technologies, or other specialized topics. Such decisions will depend on a company’s industry, strategic needs, and competitive circumstances; however, the majority of roundtable participants agreed that, “*rather than directors who are themselves experts in issue X, we should recruit directors who know how to find expert advice on issue X and ask good questions.*” A participant reported the use of such a strategy by one board: “*When management launched a transformational IT project that would change the way we do business, we brought in an outside consultant to brief the audit committee on a regular basis. It was much more effective to hire in that type of expertise than recruit it onto the board, given the level of complexity and how quickly technologies change.*”

## How Can Directors Think Strategically About Board Composition?

Many attendees at the roundtables described situations where one or more of their boards have multiple vacancies coming up in the next two-to-three years, due to planned director retirement, tenure limits, or other conditions. As one director put it, “*We are looking for ways to manage this turnover holistically, rather than replacing one individual at a time.*” Participants shared several lessons learned through the approaches taken by their nominating and governance committees:

**Start with a broad definition of potential candidates.** Roundtable participants agreed with the conclusion reached by the NACD Blue Ribbon Commission on the Diverse Board that “boards must strive for diverse composition as a means of strengthening their own ability to make wise and informed decisions. In particular, this requires gender, racial, age, and experience diversity to broaden the viewpoints, skills, and backgrounds of the individual board members.”<sup>12</sup> One director said, “*We are looking outside the traditional definition of ‘CEO experience’ to include division or region leaders of large companies, major nonprofit executives, university presidents, and so on. Successful leaders in these roles know how to cope with complexity, volatility, and are comfortable operating on a global scale.*” Another participant encouraged fellow directors to “*press our search firms to go a level past the usual specs in order to set us up for future success. Where will the interesting next generation of board leaders be coming from?*”

**Review the board’s tenure-limiting policies to ensure they are fit for purpose.** As one director observed, “*There is no one-size-fits-all solution. Term limits will be the right solution for some boards, age limits for others; and some boards have been successful without either. Boards need to ask the question, ‘Do we have an effective solution in place to remove underperforming directors or those whose skills no longer fit the company’s strategic needs?’*” Several participants suggested that boards should consider adopting a “life-cycle approach” to board service: “*We have to get out of the mindset that directorship is virtually a lifetime appointment, and that the default is renomination each year. Boards can benefit from having a mix of members at different points in their careers as directors.*”

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<sup>12</sup> NACD, *Report of the Blue Ribbon Commission on the Diverse Board: Moving From Interest to Action* (Washington, DC: NACD, 2012), 3 [hereafter cited as *Report of the BRC on the Diverse Board*], <http://www.nacdonline.org/Store/ProductDetail.cfm?ItemNumber=5814>.

**Use evaluations to help identify skill gaps on the board and inform succession planning.** McGladrey's Phyllis Deiso has noted:

For the whole board, an assessment can identify key areas in which the team can be strengthened. Individual director assessments can identify directors who are an impediment to achieving optimal board performance, which can provide an opportunity to improve that director's performance or, in some cases, remove him or her from the board. Assessments of the current board's capabilities can also highlight areas in which key skills and experience required to support the strategy are lacking and should be added. Closing that gap can greatly enhance the board's ability to do its job. It can also minimize the risk of poor strategy execution by providing the board access to the input and guidance of directors with relevant critical skills and insights.<sup>13</sup>

In the view of some roundtable participants, *"It's difficult to tell a director they're no longer contributing, so we default to age limits."* Others reported a different experience: *"We do individual evaluations every year, asking a yes-or-no question about whether each director is bringing value to the board. If the majority says no, we have to act."* While performance assessment of individual directors is still a minority practice (see "Trends in Board Composition and Evaluation," page 2), attendees at the roundtables agreed that effective evaluation processes at all levels are essential to enhancing board performance: *"We spend our careers in management being evaluated and evaluating our teams. As board members, we need to be open-minded enough to hold ourselves accountable that we have the right directors with the best skills to match the company's needs."*

**Make ongoing director education an expectation.** Roundtable participants emphasized the fact that the process of enhancing skill sets on the board should start with the current director slate. At one participant's company, *"each board meeting agenda includes time for directors who attended an outside conference to report on their takeaways. It is a way of sharing the benefits of the program with fellow directors, but it [has] also created a culture where attending these programs is the norm."* Several other participants described approaches to regularly scheduled education at the full board or committee level, including briefings focused on specific industry issues, global economic trends, or updates from corporate functions such as marketing or human resources.

See Appendix A for selected recommendations from the *Report of the NACD Blue Ribbon Commission on the Diverse Board*. Appendix B contains a list of suggested questions for directors related to board composition.

## How Can Directors Effectively Communicate to Investors About the Makeup of the Board?

In discussions with NACD throughout 2014, institutional investors have made it clear that they are seeking greater clarity and context regarding board decisions on composition, director succession planning, and board evaluation processes.<sup>14</sup> Roundtable participants recognized the challenges that exist on both sides: investors must assess director skills and boardroom dynamics from a completely external vantage point, while boards may find it difficult to sum up directors' qualitative attributes or the nuances of board processes. In the words of one attendee, *"It can be a real challenge to communicate skills, for example—how do you capture what a director learns from attending hundreds of audit-committee meetings on multiple company boards over the course of years of board service?"*

<sup>13</sup> Phyllis Deiso, "Commit to In-Depth Board Assessments to Decrease Risk, Increase Effectiveness," *NACD Directorship* (blog), Nov. 24, 2014, <http://www.nacdonline.org/Magazine/Article.cfm?ItemNumber=12492>.

<sup>14</sup> NACD, *Investor Perspectives: Critical Issues for Board Focus in 2015* (Washington, DC: NACD, 2014), <http://www.nacdonline.org/InvestorPriorities>.

Despite the challenges, the objective is clear: *“We need to be able to say our board is comprised of these individuals for this reason—not just some boilerplate list of skills. Is there a way to explain why we think this group of directors is the right group? Why is the whole [board] even better than the sum of its parts?”* NACD has consistently encouraged boards to consider going beyond disclosure requirements in order to maximize transparency of shareholder communications. This extra effort includes discussing whether direct engagement between selected directors and investors on appropriate governance topics is needed. As a first step, every board can ask management to provide a detailed report of feedback received from major investors on the comprehensiveness and clarity of disclosures about board composition, director qualifications, board evaluations, and related processes.

Overall, directors at the roundtables agreed with an observation made by one attendee who said, *“the table stakes for board members are going up. If we believe our board is an asset to the company—and we do—then we need to act and communicate accordingly.”*

### Related Resources

NACD, *Nominating and Governance Committee Chair Advisory Council Summary of Proceedings*, Apr. 22, 2014

NACD, *Investor Perspectives: Critical Issues for Board Focus in 2015*

NACD, *Report of the NACD Blue Ribbon Commission on the Diverse Board: Moving From Interest to Action*

## APPENDIX A

### Excerpts From the *Report of the NACD Blue Ribbon Commission on the Diverse Board: Moving From Interest to Action*<sup>15</sup>

A board's performance relies on its understanding of the company and its operating environment. In today's business landscape, the board cannot properly fulfill this responsibility without having directors who reflect the composition of its stakeholders, particularly its employees and customers. Put simply: corporations will not be able to build or maintain a successful enterprise that yields sustainable long-term shareholder value without bringing a greater variety of perspectives into the boardroom.

Every director has a responsibility to set a tone at the top that embraces and leverages this new reality. The board has a unique role in diversifying its own membership and, ultimately, the leadership and workforce of the organization.

Approaches to building a diverse board will vary. There are some actions, however, that this commission considers indispensable in overcoming any barrier. At a minimum, the commission believes the following four actions should be taken by all boards that face such barriers:

- *Review and evaluate board composition.* Diversity discussions should be rooted in company strategy and board evaluation. A candid exchange of views on both issues will be crucial to understanding the board's composition and the company's strategic needs.
- *Expand horizons for seeking candidates.* Boards should consider setting a nominee-slate target for the nominating/governance committee and recruiters.
- *Improve director evaluations.* Board and individual director evaluations must be strengthened to hold the board accountable as an effective oversight body.
- *Preserve, enhance, or consider adding tenure-limiting mechanisms.* Boards should consider selecting the most appropriate tenure-limiting mechanism for their company. Moreover, boards must adhere to the outcome when a tenure-limiting mechanism is triggered even if the director is still an active participant.

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<sup>15</sup> NACD, *Report of the BRC on the Diverse Board*, 2–4.

## APPENDIX B

### Questions for Directors

Board members can use the following questions in discussions related to the composition of the board and key committees:

- How frequently does your board assess its current composition relative to the company's long-term strategic goals and needed skill sets? What methods or tools does your board use to do so?
- Which director skill sets have you added recently to the board, and which do you plan to recruit for in the future?
- How far in advance does the nominating and governance committee plan for filling vacancies on the board? What special considerations, if any, are involved for key committee vacancies and succession of committee chairs?
- What practices and tools does your board have in place to ensure directors' skills and knowledge stay current? What types of continuing education do board and/or key committee members receive?
- How does your board address directors whose skill sets no longer match the company's strategic needs? How does your board deal with underperforming directors? What are the similarities and differences in the way the nominating and governance committee (and/or independent chair or lead director) handles these situations?
- What questions are investors asking about the relationship between corporate strategy and board composition, director tenure, and succession planning? Do the company's major investors understand how the board assesses its own performance and how it acts on the results of performance evaluations?