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Boards of Directors Trends, Challenges, Opportunities

The market is demanding increased transparency and accountability. New compliance mandates, regulations and shareholder activism are the drivers, but governance is more than just compliance.

By Susan F. Shultz

Boards of directors matter — and now they matter more than ever. The market continues to demand increased transparency and accountability. New compliance mandates, regulation and shareholder activism are the drivers. Boards and their constituencies are clamoring for more strategic engagement and value-add by the directors. Yet this trend seems to be in stark contrast to the drumbeat for compliance and regulation.

How can boards balance the pressures from their attorneys, auditors and regulators to be risk averse (Read: safe) with Wall Street calling for creativity, innovation and job creation? Challenges and opportunities for boards have never been greater, and good governance is more than just compliance.

Here are 11 key issues confronting today's boards.

❮ BOARD COMPOSITION ❯

Good governance means good people with unwavering integrity. When building their boards, leading companies are moving from friends of friends and celebrities to board members who will meaningfully contribute to the business. The trend is to "matrix" the existing board, catalog future needs and proactively recruit the best directors to fill the gaps.

Boards are now required to specify director qualifications in their proxies. In addition, NYSE Euronext requires boards to disclose not only *who* they recruit, but *how* they were recruited.

The first preference is to recruit active CEOs and secondly, retired CEOs. Yet 54 percent of all S&P 500 CEOs do not serve on an outside board. Today, the average CEO sits on only 0.7 boards, compared with an average of two outside boards 10 years ago.

More than half of all companies limit the number of public boards on which their CEO may serve. With the need for increased oversight and financial accountability, this trend might presage more board opportunities for financial experts. However, the *Spencer Stuart Board Index* records the smallest intake of new independent directors since 2001.

Still, one-third of all directors recruited last year were financial experts, and half of all boards responding to the Spencer Stuart survey are seeking directors with financial expertise. Forty-eight percent want industry expertise and 37 percent are looking for international experience. Regulatory, risk, technology and marketing expertise are also in strong demand. Despite common perceptions, the overwhelming majority of directors serve on only one board.

Only a quarter of new appointees are active senior executives, down from over half a decade ago. Twenty-one percent of the new independent directors are first-timers on outside public company boards and more new directors are retired CEOs (17 percent, up from 9 percent in 2000).

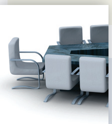
Globally, 40 percent of boards have no women, according to GMI Ratings' *2012 Women on Boards Survey*, and diversity has stagnated, despite the new requirement that boards disclose how they have addressed the issue. In its *2010 Global Boardroom Study*, Heidrick & Struggles notes that only 13 percent to 16 percent of all U.S. directors today are women, and a mere 162 minority directors sit on the boards of the top 200 S&P companies.

GLOBALISM

Boards of directors now recognize the importance of globalism in the makeup of their boards. The Spencer Stuart study reveals that 11 percent of the 302 new independent directors in 2010 were from outside the U.S.

If a company has a significant investment in a region, it can gain a tremendous advantage from a board member who has deep and relevant experience in that marketplace. Interestingly, industrial companies added the most international directors this year, comprising one-quarter of their new board members.

There are additional considerations when recruiting a foreign director. Among them: Are there conflicted allegiances, such as could be the case in China with state-owned enterprises (SOEs)? Does a potential director understand and subscribe to good governance practice? Are they capable of discussing and voting on all the issues, not just those affecting their region.



SUCCESSION PLANNING

Succession planning is increasingly recognized as a critical board challenge, both for executives and board members. Fewer than two-thirds of directors are satisfied with management succession plans, and well over half want to spend more time on succession planning. The trend is to make succession a recurring agenda item.

A textbook example of smooth succession was at Avnet Inc., the $26 billion electronic components distribution company, where Rick Hamada, the successor to CEO Roy Vallee, was identified a full year prior to the changeover and took over as CEO in a seamless transition. Too often, in cases such as at Hewlett-Packard Co., CEOs and their boards simply do not have effective succession plans in place. As CEO tenure is shortened, the need escalates proportionately; 13 percent of Fortune 500 CEOs turned over in 2011, a six-year high.

COMPENSATION

Akin Gump, an international law firm, notes that directors rank executive compensation as their number one concern. The say-on-pay vote, though advisory, gives shareholders a vote and tremendous influence on executive compensation practices.

Ten companies have been sued because of negative votes on pay, despite the fact that these are "advisory" votes. All of these "no" votes followed Institutional Shareholder Services (ISS) recommendations, according to Michael Reznik of compensation consultant Frederic W. Cook & Co. Inc.

The 2,000-page Dodd-Frank Wall Street Reform and Consumer Protection Act calls for 11 new regulatory bodies to oversee implementation of new regulations. One of the most potentially burdensome rules is to disclose how the pay of the CEO compares to the median employee, but the rule does not prescribe how to account for part-time, international or low-wage differentials.

Executive compensation continues to receive the greatest focus, but director compensation is gaining attention.

BOARD TURNOVER

The most popular subject in corporate governance today is how to fire a director. There is nothing wrong with thanking an underperforming or less-productive director for his or her service and bringing on a new director who can add more value. Various factors can complicate how the board handles underperforming directors, such as those who made exceptional contributions in the past or those subject to external pressure for removal, perhaps from shareholder groups.

Because this is such a difficult issue, nearly three-quarters of S&P 500 boards have adopted mandatory retirement policies for directors — up from 58 percent in 2000 — but the retirement age is rising. Spencer Stuart finds that 79 percent set it at 72 or older versus 37 percent in 2000.

Ideally, directors should be retained — and removed — on merit, not on age. At 70 years of age, former U.S. Secretary of State George Shultz was automatically removed from the board of Bechtel Corp. Think of the value a powerful global leader could bring to a global construction company like Bechtel, even after the age of 70.

EVALUATIONS

Beverly Behan, former head of governance at Mercer Consulting, states in her book, *Great Companies Deserve Great Boards*, "Assessment is one of the most powerful interventions available for turning a good board into a great board." Behan also finds that independent evaluations objectively benchmark board and director effectiveness and provide accountability to stakeholders and shareholders.

According to the Korn/Ferry Institute, 96 percent of S&P 500 company boards of directors conduct a review each year, but fewer than half evaluate the effectiveness of the audit committee. To address this critical performance metric, Financial Executives Research Foundation (FERF) partners with The Board Institute to develop and update the content for *The Audit Committee Index*, a web-based, independent education and evaluation tool.

The next frontier will be individual director evaluation. Today, less than one quarter of public company boards evaluate individual directors.

As noted in a recent study by accounting and audit firm PwC, only 11 percent of board members responded that their whole board evaluation process is "very effective;" 43 percent feel that there is significant room for improvement, rating their current process only "somewhat effective" or "not at all effective."

On using comprehensive, independent board evaluations that address risk management and validate the performance of the board to its constituencies, 79 percent of directors say an effective board evaluation is the "most important technique for ensuring that directors improve or continue to perform at peak levels." The trend is to move away from ad hoc, cumbersome, in-house questionnaires cobbled together and assembled by hand.

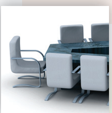
❮ SHAREHOLDER ACTIVISM ❯

Law firm Latham & Watkins reports that, as presently constituted, proxy access will allow shareholders holding 3 percent or more of a company's stock to bypass the board's nomination process and nominate directors directly. Proxy access could disrupt the boardroom as groups lobby for candidates who support their positions.

The danger is that the process of director recruitment will be politicized and skewed against truly balanced boards that include strategic industry experts and directors who are global, female, new to board service or otherwise diverse.

The best alternative seems to be to fold shareholders' nominees into the existing process, evaluating the prospective directors against mutually agreed-upon objective criteria and other qualified candidates.

Shareholders are increasingly influencing board dynamics and processes, the most obvious area being executive compensation. Objective evaluations can help validate the board to shareholders, and boards will begin to communicate more directly with shareholders, as well.



❮ BOARD LEADERSHIP ❯

The role of the board's chair is to facilitate, manage, engage and guide the board process and the directors, allowing the CEO to focus on the substance of the business, its mission and strategic plan and execution.

Forty-six percent of companies separate CEO and chair positions. However, just over half of those board chairs are considered independent. The Dodd-Frank Act requires companies to disclose whether the CEO and the chair are separate, and if the chair is independent. The concern is whether it is appropriate for the CEO to chair the very board that has responsibility for his or her evaluation, compensation and succession. When underperforming and overpaid CEOs are controlling the board, reform is extremely difficult.

Making the annual board, committee and director evaluations more robust and independent helps identify performance issues at an early stage.

❮ COMMITTEE MEETINGS ❯

Has too much work been delegated to committees? What sorts of functions are best left to the entire board?

The full board is responsible for key decisions, including selecting the CEO, risk oversight, executive compensation and succession planning. Committees appropriately dive more deeply into these issues. Some of the tension revolves around boards tending to cross the line into micromanagement; the number of committees a director can effectively serve on; rotation and leadership of committees; the number of committees; and access to committee meetings by non-committee members.

To accommodate these concerns, more boards are scheduling key committee meetings so that board members who are not on the committee can attend.

❮ RISK ❯

Risk is an escalating, hugely multi-faceted challenge for boards that must address external, global, internal, reputational, product, competitive and technology risks. There are growing numbers of risk managers, typically with financial expertise. The year 2010 was the first year for companies to comply with U.S. Securities and Exchange Commission rules that require disclosure of the board's role in risk oversight and the relationship between a company's compensation policies and employee risk-taking.

Dodd-Frank headlines the regulatory changes put in place to allegedly control future meltdowns. Boardmember.com finds that 88 percent of directors expect government regulation to increase next year. Advisen Ltd. notes that SEC investigations and enforcement actions will also increase, due, at least partially, to the rich whistleblower incentives enacted by the Dodd-Frank Act, which provides that whistleblowers can collect between 10 and 30 percent of amounts that are recovered over $1 million.

Ultimately, crisis management is about people and about trusting the board to do the right thing. Morality and performance cannot be legislated. Increased regulation raises the specter of overreliance on compliance and dampens initiative. More than half of audit committees could be more effective in linking risk and strategy, according to a recent study by accounting and audit firm KPMG.

Crisis management today is a critical aspect of risk management. Apart from the financial services companies and others required by Dodd-Frank to have separate risk committees, most companies are choosing to address risk at the level of the full board.

A looming aspect of risk is technology exposure. For example, employees at Honeywell International bring clean laptops and PDAs into China and send emails in packets, so key communications are not transmitted in their entirety. A KPMG study reports that cyberrisk is the second highest systemic risk companies currently face.

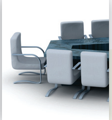
In addition, in a KPMG forum, less than one-fifth of directors said they were satisfied with their discussions with management about the impact of social media and emerging technologies on the company's strategy.

Though audit committees have responsibility for information technology security at about 70 percent of boards, 62 percent of audit committees say they are not briefed on the company's cloud plans, and 77 percent are not briefed on the company's social media activities. Only 8 percent of audit committees are satisfied with their readiness to respond if a crisis "goes viral" on social media.

Obviously, there is a serious disconnect relative to digital and social media. What are the policies relating to employee emails? Seventy percent of companies restrict use of social media, but how can that be enforced? It can be segmented into internal risks and external, anticipated and unanticipated. But, how to manage these risks?

Information is no longer closely controlled and meted out by the board and top management. Boards are in the uncomfortable position of reacting to the forces — and onslaught — of social media.

A second concern is the glut of data. Companies will generate more data in the next two years than in all of history. It is estimated that only some 5 percent of the information now collected in databases is useful. Loss of control is a tremendous hazard. In December, "Anonymous" hacked Stratfor (Strategic Forecasting Inc.), ironically a global intelligence information company, stealing hundreds of credit card numbers.



STRATEGY

Boards are expected to review, discuss, challenge and enhance the strategy presented by management in an effective and coherent manner. Yet, in the face of compliance and regulatory demands, boards must carve out time on their agendas to make strategy discussion a priority. KPMG reports that only 50 percent of directors believe their board's involvement in corporate strategy is both "ongoing and substantive."

The challenge is to generate ample discussion while limiting the board's role to oversight of, and not intrusion into, the development and implementation of corporate strategy. At the same time, boards must engage early enough in the process that their discussions can be substantive and influential.

The financial crisis exposed many cases of inadequate governance. Yet, according to the latest McKinsey Quarterly survey on governance, directors report that their boards have not increased the time spent on company strategy since early 2008 — seven months before the collapse of Lehman Brothers. Moreover, 44 percent of respondents say their boards simply review and approve management's proposed strategies.

Just one quarter characterize their boards' overall performance as "excellent" or "very good;" even so, the share of boards that formally evaluate their directors has dropped over the past three years.

Nevertheless, the dramatic untold stories are the hundreds of companies both public and private that have avoided crises and have succeeded because of the advice and counsel of strategic boards of directors.

Susan F. Shultz, CEO of The Board Institute Inc. (www.theboardinstitute.com), is an internationally recognized governance expert who speaks and writes on the competitive advantages of strategic boards. She founded SSA Executive Search, which recruits directors, and is author of The Board Book *(AMACOM).*

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