Exploring the Latest Trends In Board Composition and Talent Oversight

By Jesse Rhodes

In entertainment, a talent scout is always on the lookout for the next big star. A board similarly is tasked to find executives who will bring dynamism into either the boardroom or the C-suite. But where the entertainment industry is guaranteed a wellspring of song and dance hopefuls, boards are constrained to identify individuals who have the perfect blend of insight and expertise to create or execute a winning corporate strategy.

To help boards address this challenge, the National Association of Corporate Directors (NACD) convened a panel of subject-matter experts at Leading Minds of Governance–East. The discourse examined the ways in which directors can evaluate talent around the boardroom table and in the C-suite, and determine how to keep a life force of talent flowing throughout all levels of the organization. Panelists were **Linda Fayne Levinson**, director of Hertz Global Holdings, Ingram Micro, Jacobs Engineering, and NCR Corp.; **Theodore L. Dysart**, vice chair, Global CEO and Board Practice, Heidrick & Struggles; **Dennis T. Whalen**, KPMG Board Leadership Center leader; **Sandra Beach Lin**, director, American Electric Power Co., Interface Biologics, PolyOne Corp., and WESCO Distribution; **Margaret Engel**, founding partner of Compensation Advisory Partners; and **Philip Richter**, partner and co-head, Mergers and Acquisitions Practice, Fried Frank. Highlights from their conversation facilitated by *NACD Directorship* Publisher Christopher Y. Clark follow.

How do you define a high-performing board?

Linda Fayne Levinson: The board has a few clear roles. First, it needs to be sure that the company is following the right strategy, ideally for long-term value creation. The board isn't meant to create the strategy, but it needs to poke and prod to ascertain that the strategy is doable. It's astonishing how many strategies I've seen that look valuable, but when you poke and prod they're not worth the trouble. What kind of a board can do that? It has to be a board where the directors trust each other, have varied points of view, and can have the kind of robust discussion where they can challenge assumptions and discuss until the board arrives at the right answer. And it's the role of board leaders to build that kind of cohesiveness. A good board is where the individual members each contribute something, where they each have judgment, and where they're willing to think and converse and get to the right answer.

The second role of the board is to make sure the right people are in the right jobs. At some point, you will have to choose a CEO. Once you have that CEO, you have to make sure that CEO is putting the right talent around him or her. One of the roles of the board is to hold management accountable.

The third role is fiduciary duties, making sure no one is cooking the books. This part is easier, but you constantly have to ask yourself: Am I doing these three things? I think one of the biggest things boards need to think about is how they set goals for continuously improving the board. One of our roles is to be an advisor to management. So we should ask management, How are we doing? Are we focusing on the right issues?

What are the current trends in boardroom composition?

Theodore L. Dysart: There has been a lot of discussion around composition and whether a board is looking at itself or whether it needs an outsider to come in and help improve board composition. Last year in the Fortune 500, there were 399 new director appointments—that was up about 10 percent from the prior year. The average age of new directors is 58. We saw a bump in international expertise coming onto boards, which almost doubled from

PHOTOS BY DAVID NICHOLAS/LONGVIEW

last year. On the issue of diversity, progress has slowed. We have seen steady increases in ethnic and gender diversity in the past five years, and those numbers maintained last year. Thirty percent of new appointments were female; 9 percent were African American; 4 percent were Hispanic; and 5 percent were Asian. Those are the stats, but they belie the questions that more and more boards are asking: Who can make the board and management team better? What skills and experiences do they bring that provide new and illuminating insights for our business?

Companies are thinking far in advance and putting their eyes potential candidates three to five years out. And more boards and institutional shareholders are looking at tenure and tenure-limiting mechanisms. Companies are looking into these issues to decide what it means for them, their continuity, and their business cycle. Term limits can force boards into a process of continuous succession planning. The real issue is that talent is scarce. Boards still want sitting CEOs as directors, but more than two-thirds of sitting CEOs are currently on boards. Institutional Shareholder Services currently recommends restricting CEOs to serving on two outside boards, but we think they are going to narrow that down to one in the future. You have to be able to take on an element of risk if you're looking to get a certain professional profile and take someone on before they get to the CEO's chair.

What is the audit committee's role in monitoring talent?

Dennis T. Whalen: It's important for the audit committee to understand and assess the talent in the finance organization to help ensure that the right people are in place to maintain the quality of financial reporting and controls. Many CFOs are taking on additional strategic and operational responsibilities, making it even more important to have strong leaders in the controller and chief accountant roles, as well in treasury, tax, and internal audit.

To do that, audit committees should develop a deep understanding of the finance organization's culture and dynamics, as well as the performance of the CFO and other senior staff. That doesn't happen through committee meetings alone. There's not enough time during those meetings for the kind of open exchange that helps build the level of trust, confidence, and communication. It's also the work that gets done between meetings and the personal relationships that are developed.

Audit committee members know the CFO, the controller, the head of tax, and the internal auditor well. But the audit committee should also interact with management and staff below the C-level to get a better understanding of the bench strength and the talent pipeline. One way I've seen that done is for the audit committee chair to present at the company's annual controllers group meeting and spend time afterwards engaging in conversation and building relationships, creating opportunities for dialogue. Another way is for the audit committee to add a day to the front or the back end of the board trip to meet with both finance and non-finance people—to get enough interaction to understand what's going on.

The audit committee also needs to ask questions of the CFO and finance team leaders to assess whether there are any gaps. Are there succession plans in place for CFO, controller, chief accountant, treasurer, and other key finance executives? Do employees

have the training and resources they need to be successful? It's also helpful to get the views of the internal and external auditor.

How do you see board evaluations evolving?

Sandra Beach Lin: We use an outside consultant, and the process we use works quite well—it really is a differentiator. We use a lawyer who is both personable and trusted. Discussions are held in person for one and a half to two hours; the topics we cover include the board as a whole, the committees, and then the individual board members. Feedback is anonymous, and it comes back to the lead director, who then holds a call with each director. The feedback as a whole is discussed in an executive session, and then we establish what we want to improve on in the coming year. It's effective, it's impactful, and it generates the best discussion out of all the processes I've seen used. Everyone sees this as continuous improvement. And everyone buys into this process.

Based on my experience, I have a few ideas on how boards can improve. Regarding individual evaluations, add the lens of the context of strategic fit with the needs of the board and the organization for the future. Ask, how will the skills on the board fit for the future? Also, think about how to avoid evaluation fatigue. Ask, do we really need to have an in-depth analysis of the board every year?

Finally, think about how you communicate to the outside world what you're doing with your evaluations. The evaluations process is getting a lot more scrutiny than it used to. The boards I'm on have all been honing what we say about the individuals who are on the board, the skills they have, and how they are valued by the board and the company. If you add a director, let your top 20 investors know why the board made that addition.

How can boards use compensation to attract and retain talent?

Margaret Engel: Compensation plays a major role in encouraging high performance and attracting and retaining high-caliber directors. I think boards strive to achieve a few things: have a program that is simple, clear, and understandable; have the right balance of program components; and make sure there is alignment with shareholders in terms of providing a meaningful ownership stake that a director on a board can accumulate over time.

When boards and committees look at the compensation program, there are a few critical decisions that have to be made. First, consider the kind of structure you want to adopt. For example, should it be a retainer-only or a retainer-plus-meeting-fees model? The combination of retainer and meeting fees is where boards started a few years ago, and the idea was to encourage attendance at meetings. But as times change and responsibilities have increased, and as companies have tried to find directors who are advisors and always available in times of crisis, the focus has moved to retainers. At this point, 70 to 80 percent of companies have migrated to a retainer-only model.

In addition to a retainer, companies offer a portion of compensation in equity. But that also has changed. Years ago, it was stock options; now it's restricted stock units because restricted stock units give a much stronger alignment between the director and the shareholder because there's an outright ownership stake. As directors participate and accumulate shares over time, it can be a substantial wealth-

Philip Richter

creation vehicle. In addition to cash and equity, companies put in place supplemental policies to encourage good governance. It's now common for directors to be expected to retain a multiple of the retainer over a period of years. Also, constraints on hedging and pledging—practices that you would not want a director to engage in—are common. These supplemental policies can create a compensation program that can support the creation of a high-performing board.

When it comes to mergers and acquisitions (M&A), how exposed are directors to litigation?

Philip Richter: A few things have happened in recent years that I think are generally good for directors. One, the courts have become more deferential to board decisions in M&A transactions. A few years ago, nearly 100 percent of M&A deals valued at over $100 million resulted in litigation. That number has substantially decreased to between 50 and 60 percent. Another thing that has driven the reduction of plaintiff activity is that the courts are applying the business judgment rule in most M&A transactions, whereas in the '80s and '90s the court often second-guessed board decisions in M&A transactions. The courts have come to an M&A deal that is approved by shareholders in an informed vote, which frees directors from the threat of ongoing litigation. The flipside is, although the courts have stepped back, that void has been filled by investors. There's much more shareholder involvement, and they are expressing their points of view and raising questions about transactions. Knowing who your shareholders are and how they might react to transactions is important.