



Investors' View

How Boards Can Prepare for the 2018 Proxy Season

Boards looking ahead to the 2018 proxy season should prepare for unprecedented scrutiny. Institutional investors and activist investors are shining a spotlight on board composition and evaluating whether boards are composed of the diverse mix of skills best matched to company strategies and risks. Board quality is top of mind, and factors such as the relevance of director experiences, director tenure, board refreshment practices and boardroom diversity are now routinely assessed by investors.

Spencer Stuart recently invited representatives from BlackRock, the largest global institutional investor with \$6 trillion in assets under management, and the New York City Pension funds, with \$180 billion in assets and a storied history of leadership on environmental, social and governance (ESG) issues, to share their thoughts on hot issues for corporate boardrooms. Peter da Silva Vint, vice president in BlackRock's Americas investment stewardship group, and Michael Garland, assistant comptroller for corporate governance and responsible investment for New York City Comptroller Scott M. Stringer, spoke at a November 9 New York City breakfast hosted by Spencer Stuart for corporate directors. The discussion highlighted five key questions for boards to consider.

Is the board's composition a leading or lagging indicator of company strategy?

The investors urged boards to evaluate their composition in terms of having the right people to oversee the company's evolving strategies and risks over the next five to 10 years. Boards should routinely assess whether business disruptors or changes in strategy make certain skills on the board less relevant or more urgent and whether skills of current directors have become outdated. And they cautioned that boards facing special challenges, such as activists or performance issues, should expect heightened scrutiny.

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Attention to the qualifications and contributions of individual directors and board composition comes on the heels of years of investor focus on structures and policies designed to enhance board independence and accountability. The impact of this focus is far reaching. According to the 2017 *Spencer Stuart U.S. Board Index*, today 92 percent of S&P 500 companies have one-year director terms, up from 62 percent in 2007, and 89 percent have policies requiring directors to offer their resignations if they fail to win a majority vote, up from 84 percent in 2012. And in part due to efforts by the New York City pension funds, companies are increasingly adopting proxy access provisions establishing formal mechanisms for shareholders to include director candidates on management proxy cards.

With these tools and structures in place, investors can more directly influence boardroom composition by voting directors on or off a board. Now attention has turned to who is sitting in the boardroom and how director skills and qualifications align with company strategy.

Narrowly focused “specialist” directors are viewed by both investors with a skeptical eye. Noting that board seats are limited, they cautioned that no director should check only one box on a board's skills matrix. Their view: each director should add a variety of skills to the boardroom, although some directors may have a narrower set of expertise depending on the company and its unique considerations.

Are assessments the foundation of the board's refreshment strategies or are tools such as mandatory retirement ages the default mechanism for refreshment?

Both investors urged boards to energetically refresh composition based on company needs and director performance. Pointing to surveys finding that a significant percentage of directors believe one or more of their fellow board members should not be on the board, the investors called on boards to use robust assessments to drive refreshment.

73%

of S&P 500 boards have
mandatory retirement
ages in place

5%

of S&P 500 companies
specify a term limit for
non-executive directors

They consider expectation-setting equally important. By clearly articulating that board service is based on company needs and director performance, boards can emphasize that board service has a finite life, easing any future tough conversations, according to da Silva Vint and Garland.

Both said individual director assessments should include careful consideration of additional board service commitments to determine if a director is “over-boarded” and lacking the bandwidth to adequately perform the job. BlackRock generally defines “over-boarding” as: 1) a director serving on more than four public company boards; or 2) a CEO of a public company serving on more than one other public company board.

Mandatory retirement ages and tenure limitations are opposed by both investors. Such policies can serve as “crutches” enabling boards to avoid the difficult conversations when a director’s skills may no longer be relevant or if a director is underperforming, Garland said.

Despite the opposition by BlackRock, New York City pension funds and other investors, formal board refreshment policies proliferate. Almost three-quarters (73 percent) of S&P 500 boards have mandatory retirement ages in place, which has remained consistent for more than five years. Mandatory retirement ages have been increasing, with nearly all companies that have them (96 percent) setting mandatory retirement at 72 or older, compared with 67 percent 10 years ago. Tenure limits are less prevalent, with only 5 percent of S&P 500 companies specifying a term limit for non-executive directors.

Do company disclosures provide a robust and accurate picture of individual director qualifications and connect with company strategy and risks?

Both investors agreed that clear, concise and realistic disclosures of director skills and qualifications are essential and better enable investors to assess the overall composition of the board and determine whether an individual should serve as a director.

The New York City funds are pressing companies to voluntarily enhance their disclosures. In September 2017, the funds launched the Boardroom Accountability Project 2.0, calling on companies to supplement required director-specific disclosures with a matrix detailing director skills, qualifications, race, gender, ethnicity and any other key factors as determined by the board. Most companies currently don’t publicly disclose matrices. In an effort to change practices, the New York city comptroller sent letters to approximately 150 companies — all with proxy access bylaws adopted in response to his request — requesting public disclosure of matrices.

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Da Silva Vint said BlackRock is open to different forms of director skill disclosures, but he noted that matrices would make it easier to assess the directors and boards of the 4,000-plus companies in BlackRock's portfolios.

Do the board's composition and refreshment actions reflect an ongoing commitment to gender and racial diversity in the boardroom?

BlackRock and the New York City pension funds consider board diversity a fundamental dimension of board quality, and they are taking different approaches to underscore their commitment to the issue.

BlackRock will use proxy votes to urge reform. The firm expects boards to include at least two women, and in 2019 it will consider voting against directors of companies failing to meet a two-women-director minimum or show progress on the gender diversity front. Explaining BlackRock's rationale, Da Silva Vint noted that having only one woman director appears to be a token gesture and that studies have shown that more than one woman improves long-term performance.

Meanwhile the New York City pension funds are pressing on the disclosure front. A key component of the Boardroom Accountability Project 2.0 is the inclusion of gender, race/ethnicity details for each director detailed on any disclosed matrix. Garland observed that currently most companies do not provide robust disclosures of board gender, racial and ethnic diversity, resulting in investor guesswork.

Do company disclosures and communication/engagement strategies focus on strategy and value creation, providing a strong first line of defense against activists?

Noting that activists often raise valid points about company strategies and issues, the investors advised companies to focus disclosures and communications on why their plan for long-term value creation is best and why their board is best structured to oversee the plan. Both observed that activists have significantly upped their game in communicating to and engaging with investors, and they urged companies to follow suit.

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Da Silva Vint and Garland stressed that their funds take activism very seriously and carefully evaluate both sides of every activist situation with healthy skepticism. Both expressed less support for activist plans focusing on financial engineering strategies such as stock buybacks.

When it comes to director engagement with institutional investors, they advised boards to know who their shareholders are and understand their expectations for engagement.

Da Silva Vint said BlackRock wants directors to be involved on calls or in meetings. It tends to engage with companies at least once a year — generally once during the proxy season to discuss voting matters and sometimes if necessary, again in the off-season to discuss long-term term or non-voting issues. While BlackRock responds to every request for dialogue, he noted that it only engages with companies where there are issues or BlackRock owns a sizable position.

In contrast, the New York City funds focuses engagement on companies it selects for advocacy, usually via shareholder proposals that are filed as a tool to promote engagement with companies and directors, according to Garland. He said the funds want the opportunity to engage with directors at certain times, such as activist situations or when there are issues with executive compensation.

Conclusion

Finding the right talent for the boardroom and communicating the rationale for boardroom composition has never been more important. Boards can proactively anticipate issues in advance of the 2018 proxy season by examining the board and its disclosures through the lens of investors and engaging and making changes, as appropriate, to address potential issues.

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