

2018 Governance Outlook

PROJECTIONS ON EMERGING BOARD MATTERS

A Publication of the National Association
of Corporate Directors and Partners

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ABOUT THIS REPORT

2018 Governance Outlook: Projections on Emerging Board Matters is NACD's first publication of its kind, designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues likely to demand board focus over the coming year. The report begins with an introduction from NACD, highlighting survey findings about leading board priorities for 2018, and follows with six partner contributions that provide distinct insights and projections on the following themes: business risks, board evolution, litigation, workforce disruption, and cybersecurity.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2018, and (3) relevant implications and questions for boards to consider. *2018 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards prioritize their focus in 2018 and increase their awareness of emerging issues, through both detailed topical analysis and coverage of broader governance implications.

Board Evolution: The Forces Driving Board Composition and Succession

By Julie Hembrook Daum

Board evolution historically has been driven by directors reaching retirement age and, periodically, by the emergence of a profound need for new perspectives on the board—such as financial expertise after the passage of the Sarbanes-Oxley Act and, more recently, digital and cybersecurity experience or diversity.

As a result, board turnover continues to be modest. In the 2017 proxy year, S&P 500 boards appointed 397 new independent directors, and 48 percent of boards did not appoint a new director.¹

S&P 500 boards today rely overwhelmingly on formal retirement policies to promote turnover. About three-quarters (73 percent) of S&P 500 boards report having a mandatory retirement age for directors, consistent with the past five years. And retirement ages continue to rise. Today 42 percent of S&P 500 companies with mandatory retirement policies set their retirement age at 75 or older, compared with 22 percent in 2012 and just 11 percent in 2007. And few boards have mandatory tenure policies. Only 24 S&P 500 boards (5 percent) set explicit term limits for non-executive directors, with a majority of the policies set at 15 years or more. Nearly two-thirds (65 percent) of boards explicitly state in their corporate governance guidelines that they do not have term limits.

Beyond board policies, slow board turnover has been driven by the traditional mind-set that directorship is a lifetime appointment. Historically, leaving or being voted off the board before reaching an age or term limit has had a negative perception—that the director did something wrong. The result of this mind-set and prevailing board policies is that boards turn over slowly and, when they do have an opening, tend to think in terms of finding director candidates able to check multiple boxes on the board's wish list and those who can bring skills and expertise that will be relevant for 10–20 years.

The demands of the business and external forces, principally pressure from investors, are likely to change how boards think about composition and refreshment strategies. The sheer pace of change today means that companies—and boards—are having to respond to market, competitive, technology, political, regulatory, and customer changes that are coming at them faster than ever. Companies increasingly will need agile boards with the energy and expertise to deal with emerging threats and opportunities. Investors have become more vocal that board composition reflects these strategic needs.

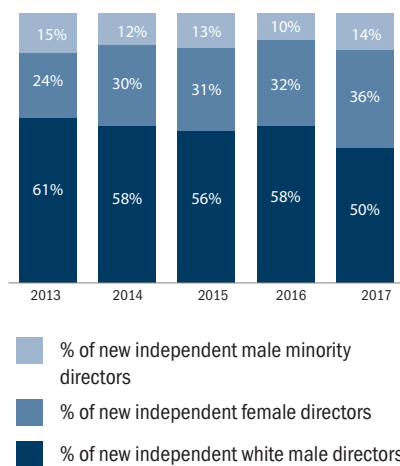
Preparing for 2018: Governance Developments on the Horizon

Here are some of the trends we believe will emerge or accelerate in 2018:

Investors will continue to push for more insight into how boards approach refreshment, and boards will respond with more detailed disclosure and increased engagement. Investor interest in board composition has never been higher. Today investors expect boards to have meaningful processes—beyond formal policies such as mandatory retirement ages—to refresh the board and maximize board effectiveness. They are requesting details on how boards review and evolve board composition and leadership in light of emerging needs. In response,

¹ Data throughout this article is gathered from the *2017 Spencer Stuart U.S. Board Index*.

Percentage of New Female and Minority Independent Directors in the S&P 500 (2013–2017)



more boards will disclose their rationale for their composition based on the strategic priorities of the business. A growing number of boards, for example, are including a detailed composition matrix that summarizes director backgrounds, ages, tenure, and independence at a glance. Others provide descriptions of the board nomination process, including an explanation of how director candidates are identified, the process for reviewing nominations and the number of new directors the process has produced in the recent past. We also expect that boards will increase their engagement with large shareholders on key governance topics, including composition. In our 2017 S&P 500 governance survey, 82 percent of respondents said management or the board proactively reached out to the company’s large shareholders; board refreshment was one of the top three investor outreach topics, with 43 percent saying their board or management team proactively communicated with investors about it.

We will continue to see new faces in the boardroom. Boards are casting a wider and deeper net to identify qualified candidates, and we expect they will continue to consider a wider variety of profiles when recruiting new directors in 2018. In the 2017 proxy year, for example, we saw the largest influx of first-time directors on S&P 500 boards; 45 percent of new directors were joining their first outside public corporate board. These first-time directors are more likely than other new directors to be actively employed (64 percent versus 42 percent). They also are less likely to be C-suite executives and more likely to have other executive experiences such as division/subsidiary leadership. More than half (55 percent) of the first-time directors are women or minorities.

The pace of director retirements will increase. U.S. boards are aging, which inevitably will spur more retirements. The average age of S&P 500 directors today is two years older than a decade ago, 63 versus 61, and 19 percent of S&P 500 directors are 70 to 79 years old.

Boards will face more pressure on gender diversity. With research showing that companies with more diverse boards perform better, more investors will push harder on boards to increase diversity.² State Street Global Advisors now “expects boards of Russell 3000 listed companies to have at least one female board member.”³ And BlackRock said in a recent quarterly report, “Ideally, we believe boards should commit to adding at least two women directors.”⁴ During the 2017 proxy season, State Street announced that it voted against the chair or most senior member of the nominating and governance committee of 400 all-male boards,⁵ and BlackRock voted against nominating committee members of a few boards

² Christopher P. Skroupa, “Gender Diversity On Boards—A Driver Of Value,” *Forbes*, June 27, 2016.

³ State Street Global Advisors, “Proxy Voting and Engagement Guidelines: United States,” 2017.

⁴ BlackRock, *Investment Stewardship Report: Americas: Q2*, June 30, 2017, p. 9.

⁵ Emily Chasan, “After Fearless Girl, State Street Puts Men-Only Boards on Notice,” *Bloomberg*, July 26, 2017.

for failing to address investor concerns about boardroom diversity.⁶ In explaining its decision, BlackRock said diverse boards “make better decisions.”⁷ Boards are taking steps to enhance boardroom diversity. Half of the new S&P 500 directors in the 2017 proxy year are women and/or minorities. Female representation among new directors rose to 36 percent in 2017, a 20-year high, while 20 percent of new independent directors are minorities, defined as African-American, Hispanic/Latino, or Asian.

The Implications for Your Board

As these forces gain steam in 2018 and beyond, we believe boards will increasingly establish mechanisms to refresh themselves more frequently and embrace a continuous improvement mind-set. In particular, forward-looking boards will think about board composition in terms of an ongoing refreshment strategy, recognizing that business is moving fast and different kinds of people will be needed at different times. With this in mind, we have identified four best practices for board composition:

View director recruitment in terms of ongoing board succession planning, not one-off replacements.

Investors expect that boards evaluate board composition holistically, in the context of the company’s long-term strategy, the current business environment, and the diversity of stakeholders. Led by the nominating/governance committee, boards should periodically review the skills and expertise on the board to identify gaps based on changes in strategy or the business context. The annual board assessment is a natural platform for the full board to review its composition and discuss the expertise that it will need in the future.

Embrace a continuous improvement mind-set.

As they reduce reliance on mandatory retirement to drive turnover, more boards will embrace individual director assessments to understand the contributions of directors and whether their skills continue to be relevant given the current and future needs of the business. In 2017, just over one-third (37 percent) of S&P 500 companies reported some form of individual director assessments in their evaluation process, a small increase from 34 percent in 2016. But the recently published *2017–2018 NACD Public Company Governance Survey* indicates that the practice of assessing individual directors appears to be gaining momentum in boardrooms; 60 percent of respondents said their board includes individual director performance in the evaluation process, up from 41 percent the prior year. Most individual director evaluations are conducted annually (89 percent). High-performing boards also will assess the culture and dynamics in the boardroom to identify ways to operate more effectively, and, increasingly, they will adopt a continuous

One way boards can combat the perceived stigma attached to leaving a board before the mandatory retirement age kicks in is to set term expectations when new directors join.

⁶ Emily Chasan, “BlackRock Puts Its Votes Behind Proposals to Get Women on Boards,” *Bloomberg*, July 13, 2017.

⁷ BlackRock, “Our engagement priorities for 2017–2018,” 2017.

feedback loop, where they spend a few minutes at the end of every meeting asking themselves questions like, “How did that go? What could we have done better? Did we make a meaningful contribution?”

Set expectations for appropriate tenure at both the aggregate and individual levels.

One way boards can combat the perceived stigma attached to leaving a board before the mandatory retirement age kicks in is to set term expectations when new directors join. Long-standing board members often are surprised when they are asked to leave because things have been left open-ended. Setting expectations at the outset reduces the element of surprise. Furthermore, individual directors should be encouraged to think critically about their own contributions and whether the experience they bring is as relevant today as when they joined the board. The best boards create an environment where directors are willing to candidly consider whether their skills still match the company’s strategy each year and acknowledge when the board would benefit from bringing on different expertise. Thinking about director tenure in this light also will be important for attracting younger directors. The next generation of directors isn’t interested in staying on a board for the long term; they want to be valuable over a period of time and then leave.

Proactively communicate the skill sets and expertise in the boardroom, as well as the roadmap for future board succession.

Investors are looking for a well-explained rationale for why the group of people and each individual sitting around the board table are the right ones based on the strategic priorities of the business. They also want assurances that the board has processes in place to continue to evolve board composition in light of emerging needs. More broadly, investors want to understand the board’s approach to board renewal and that it regularly evaluates the contributions and tenure of current board members as well as the relevance of their experience. Sharing the board’s thinking about the types of expertise needed on the board—and how individual directors provide that expertise—is increasingly considered best practice. Publishing a skills matrix is one way some boards are providing that detail.

Five Questions for Board Composition

1. Do we regularly conduct a side-by-side comparison of directors’ skill sets and experiences against the company’s strategic agenda?
2. What mechanisms are we using to ensure board refreshment?
3. Have we fostered an environment that encourages individual directors to think critically about their contributions and the relevance of their skills to the company strategy?
4. Are we using our annual board assessment and regular executive sessions to assess the culture and dynamics in the boardroom and identify ways to operate more effectively?
5. Have we clearly communicated with investors the boardroom processes in place to ensure we continue to have the best group of people on the board?

Conclusion

Given the pace of business change today, companies increasingly need agile boards with the expertise to guide the company amid emerging threats and opportunities. And investors increasingly expect that boards will embrace rigorous practices to ensure they have the right expertise in the boardroom to respond to evolving market and competitive demands. The highest-performing boards will adopt a continuous improvement mind-set, ensuring that their composition evolves in light of new strategic imperatives.



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