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Governance Takes Center Stage

10 Best Practices for Boards

After years of gradually gaining momentum, investor attention to governance issues has suddenly spiked. Traditional institutional and activist investors have become more explicit in calling on boards to demonstrate that they are being thoughtful about who is sitting around the board table and that directors are contributing. Investors want to make sure that boards are diligent in defining the skill-sets needed around the table and recruiting the right directors, planning for CEO succession and evaluating their own performance. The responsibility for driving many of these areas falls to the board's governance committee. As one director told us, the governance committee has become the new center stage committee.

With governance garnering more attention than ever, we set out to identify the best governance practices for boards as part of this year's *U.S. Technology Board Index*.

Based on our work with boards, we developed our own list of priorities, but wanted to gauge whether technology company boards face any unique challenges related to corporate governance. We asked six technology company directors to weigh in on the list and the issues that their boards are prioritizing:

TOM A. ALBERG, managing director of Madrona Venture Group and a principal in Madrona Investment Group, serves on the board of Amazon.com.

JOHN G. CONNORS, managing partner at venture capital firm Ignition Partners, serves on the boards of Splunk and Nike.

MERCEDES JOHNSON, former senior vice president and chief financial officer of Avago Technologies Limited, serves on the boards of Intersil Corporation, Juniper Networks, Micron Technology and Teradyne.

EDWARD A. KANGAS, former chairman and CEO of Deloitte, Touche, Tohmatsu, serves as the non-executive chairman of United Technologies Corporation and Tenet Healthcare Corporation. He also is on the boards of Hovnanian Enterprises, Intuit and Intelsat S.A.

CATHERINE KINNEY, former president and COO of the New York Stock Exchange, serves on the boards of NetSuite, MetLife, MSCI and Quality Technology Services.

ABHIJIT Y. TALWALKAR, former president and CEO of LSI Corporation, serves on the board of Lam Research Corporation.

APPROPRIATE OVERSIGHT OF A FORWARD-LOOKING CORPORATE STRATEGY, INCLUDING HOLDING THE CEO ACCOUNTABLE FOR STRATEGIC OBJECTIVES

Oversight of the business strategy always has been a core responsibility of the board, but strategic discussions have become more urgent in the past few years as the threats and opportunities facing companies have become increasingly dynamic. The CEO and his or her team take the lead in developing the strategy, but the board must be fully involved, challenging assumptions and the soundness of the strategy, fine-tuning where needed and measuring the CEO's performance against a set of agreed-upon objectives.

Kangas argued that all companies benefit from having a computer financial model that the board and top management can use to evaluate and predict the effects of strategic decisions and external factors on the company's growth, balance sheet, investment levels, liquidity, etc. "When a board can really think about the business as a financial model and enterprise, they become better at making strategic decisions and understanding the impact of various forces on the company," he said.

One of the most challenging aspects of this process for boards is measuring management's performance against strategic objectives, said Talwalkar. "How do you enable the board to assess execution against a strategy, when you're dealing with high-level three- to five-year objectives, and a whole bunch of tactics underneath them, in an industry that is constantly changing? A lot of boards will say they are spending a lot of time discussing strategy, but I don't know if a lot of boards will say they have a very clear and precise way to monitor execution against that strategy on at least a twice annual basis. That's an area that probably needs more improvement."

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COMPENSATION PLANS ALIGNED WITH LONGER-TERM PERFORMANCE

Aligning executive compensation with company performance is a top issue for investors, and one that is likely to gain even more attention as new reporting rules take effect requiring companies to disclose how CEO compensation compares with average employee compensation. "How compensation is established has become a very important issue. The alignment of compensation plans with the performance goals for the CEO and top five executives is a very hot topic in the eyes of the investors," said Johnson. "Some boards do a better job than others, but I think that's high on everybody's mind from the investors' perspective." In particular, investors want to see compensation linked with the performance measures they care about, especially long-term performance tied to total shareholder return, said Talwalkar.

MEANINGFUL AND RIGOROUS BOARD EFFECTIVENESS EVALUATIONS, INCLUDING INDIVIDUAL DIRECTOR ASSESSMENTS

A robust board assessment covers a wide range of factors that can help or hinder board effectiveness, including board composition, committee organization, the quality and timing of information provided to the board, board engagement in strategy and succession planning, and the culture and climate in the boardroom. Consensus is growing in support of conducting individual director assessments as part of the board effectiveness assessment, though the practice still faces some resistance. "It's a painful process to go through many times, but it's a healthy process," said Johnson. "To me, it's most effective to have an outside facilitator who can turn the feedback into constructive criticism, which only helps you get better as a board member."

BOARD SUCCESSION PLANNING AND REFRESHMENT

Having the right skills around the table is critical for the board's ability to provide the appropriate guidance and oversight to management, and the capabilities and perspectives that a board needs can evolve over time as the business context changes. But the topic of refreshment can be a highly charged one for boards, as it often gets caught up in discussions about director tenure, mandatory retirement and term limits.

Boards don't want to focus on numbers, recognizing that directors can be valuable contributors — or not — regardless of their age or tenure. Ideally, boards will discuss composition needs regularly and forge agreement about the right degree of director turnover so directors become comfortable with the need to inject new skills, even if it means leaving a board before hitting the retirement age. "It really starts with directors asking themselves what's the right thing for the company and the management team and the investors who they're representing," said Kinney. "You want to have the right set of skills, but the board has to be refreshed periodically. Even a board that conducts individual director assessments still has to have the wherewithal to do that."

DIVERSE BOARD COMPOSITION, WITH THE INDEPENDENT EXPERTISE NECESSARY TO PROVIDE MEANINGFUL OVERSIGHT AND INPUT TO MANAGEMENT

The difference between a good board and a great one is the quality of the directors sitting around the table, said Connors. “Can you have fierce discussions when necessary and help to push a proactive strategy? That’s the difference.”

Johnson agreed and said she sees the diversity of perspectives at play in discussions about risk. “On one of my boards, we have very diverse risk appetites. A very interesting set of discussions take place when big decisions have to be made because everybody weighs in. It may be an arduous process to get to a decision, but it’s a very healthy process,” said Johnson.

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Kangas also sees a need for what he calls “board stature” especially for companies facing major opportunities or challenges such as activist shareholder interventions, takeovers, and merges and acquisitions. “By stature, I’m talking about how the board as a composite would be viewed by outside parties. Is it a board that is highly regarded? Is it a board that an activist would consider a mature group of people able to engage productively? Therefore, you have to look for people who have serious board experience, which could be a really good CEO; someone who has been through hostile takeovers; someone who has worked with an activist shareholder on a board; someone who the SEC would respect; someone who ISS knows and respects.”

ROBUST, BOARD-LED CEO SUCCESSION PLANNING

CEO successors and succession plans are products of thoughtful, diligent planning by both the board, which oversees the process, and the CEO, who is responsible for management succession at senior levels, including the early identification of any inside CEO contenders. The best processes drive agreement about the long-term strategic direction of the company and the criteria for CEO selection based on the future needs of the business. Boards also should develop contingency plans to deal with succession scenarios that may force an accelerated CEO transition, such as performance problems, a health crisis or other personal reasons.

Corporate boards understand CEO succession planning is their responsibility and take the responsibility seriously, but many find it difficult to navigate what can be challenging interpersonal dynamics. “Some boards do it exceptionally well, some boards don’t, and that’s a function of the CEO and whether the CEO is openly engaging the board and working with the chairman to lead this process,” Talwalkar said. “The CEO has to feel he or she has tremendous security around this particular topic and drive it.”

ATTENTION TO THE BOARD CULTURE AND ITS INFLUENCE ON BOARD PERFORMANCE

Culture tends to be underappreciated as a component of board effectiveness. On boards with a strong, healthy culture, directors are well-prepared, participate in dynamic debate on core issues, tackle the issues that matter most and respect decisions once they are made. On troubled boards, directors do not devote sufficient attention to discussing issues and struggle to make important decisions, or there can be an environment where individuals place their own personal agendas and egos above the goals of the board.

"There's got to be trust," said Kinney. "There's got to be a working group and it's got to work well, because if it's not working well, that's as much of a problem for the management team as it is for the board itself."

DEFINING THE ORGANIZATION'S RISK TOLERANCE AND ESTABLISHING A FRAMEWORK FOR APPRAISING THE QUALITY OF RISK ASSUMPTIONS AND MANAGEMENT

Risk management is an area where expectations on boards have changed dramatically, and boards' approach has evolved to become more in-depth, broader in scope and influenced by real-life scenarios. Cyber risk is especially top of mind in terms of its impact on business continuity and brand reputation, particularly in an environment in which a narrative about a company or issue can ignite and quickly spread on social media. "The board worries about results and the brand. With cybersecurity issues, the brand is what is affected immediately and sometimes profoundly," Connors said.

Responsibility for risk oversight may be spread among different committees: audit, risk, finance and others. "We have a risk and finance committee which serves as a quarterback, because risk management is a shared responsibility among several committees. All committees are analyzing and monitoring our risks and evaluating whether there are any emerging risks," said Kinney.

Boards also need to be aware that the heightened sensitivity to risk has the potential to stifle innovation and creativity. A strong board will acknowledge that risks are inherent in any business that is going to deliver long-term value to its shareholders. "Many large company boards are too risk averse. While it's the board's responsibility to think of the 1-percent-chance risk issues that could put the company's existence at risk, it's also the responsibility of the board to push companies to be more innovative and to certainly not get in the way of innovation. Too many boards are risk averse when it involves new business initiatives and not willing to challenge deep-seated management beliefs about the invincibility of existing businesses that may be eclipsed by changing business models," said Alberg.

PROACTIVE ENGAGEMENT WITH SHAREHOLDERS

Given investors' growing desire for direct engagement with directors, more boards are establishing frameworks for investors to raise questions and participate in meaningful, two-way discussions with the board. Some boards are developing new protocols to enumerate responsibilities related to shareholder engagement. One approach is to adopt the 10-point protocol developed by the Shareholder Directors Exchange, which offers guidance to U.S. public company boards and shareholders on when such engagement is appropriate and how to make these engagements valuable and effective. For some boards, it may make sense to establish a shareholder engagement committee.

Several directors said they find value in these direct interactions with investors, which can provide insight into how the company is viewed by investors as well as investor priorities and concerns. "It's valuable. It's very important, and the time to do it is before there's a problem," Kangas said.

SMART ONBOARDING TO ENSURE THE SUCCESS OF NEW DIRECTORS

New directors today are expected to get up to speed quickly so that they can begin contributing as soon as possible after joining the board. While new directors can learn about governance requirements and trends from any number of training programs, much of a new director's onboarding must come from the company itself, Johnson said. "The company itself, its markets, competitors and products — this information has to come from the company, either other board members or management. Nobody has a lot of spare time to be doing that, but it's necessary. New directors also need to be proactive in seeking out education as well as a support system at the board level."

For many boards, improving director onboarding represents an opportunity for growth, especially in the areas of providing early exposure to management and building those relationships, said Alberg. "New board members should meet one-on-one with relevant top executives. Often they meet during interviews, but they should also meet after they have been appointed. Boards also should spend more time acclimating new directors to the culture and dynamics of the board. The issue is, as a director, you want to add value in areas that you have expertise but you do not want to be viewed as getting too involved in terms of reaching out to management."

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