The Future of Boards

> *"Gone also are the days when being on a Board of Directors was seen primarily as a prestige position and supervisory role. Being a Board Member is now about active leadership, personal accountability and senior executive coaching rather than passive supervision."*
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> From *Why Good Boards Fail*,
> Stanton Chase, September 2016

Globally, boardrooms are evolving. Heightened scrutiny, empowered investors, rising competition, regulation and technological disruption have combined with the record pace and unpredictability of change to dramatically alter how boards are comprised and how they operate. This perfect storm is shaking up board composition, expanding and redefining what is expected of boards, and fundamentally changing what it means to be a director.

What is different? Justus O'Brien is Co-leader of Russell Reynolds' Board and CEO Advisory Group, and serves as a Managing Director in the New York office. "The role of the board and the demands on board members have evolved significantly, with more scrutiny, and more required of directors including much more engagement around strategy, investor engagement, and empowerment at the board level in long-term CEO succession planning."

O'Brien said "The investor community has had a role in all this—big, institutional investors who are advocating refreshment strategies, advocating for greater diversity, and demanding that boards strike a good balance between long-term requirements and short-term results. All of these pressures have led to a lot of change, and driven companies and boards to rethink how they're doing."

For example, Allan Marks, Managing Partner, Australia, and Regional Leader of the Board Services Practice for APAC at Boyden, says "There is a greater focus on boards to assess the capabilities they need and try and be sure that there is a balanced portfolio of expertise within the boardroom. Some of that is related to the industry the organization might be in, and some of that is related to skills in other areas such as technology disruption. So it's changing in that context."

Boards are also broadening the range of skills and experience that they are seeking, to serve both the board and the company. Carter Burgess Jr., Managing Director and Head of the Board Recruiting Practice at RSR Partners in Greenwich, CT said "Boards are doing a much better job of bringing on new members who have particularly relevant experience, perspective, and expertise. This reflects the fact that boards are devoting more time, thought and effort into creating their candidate profiles within the context of a more comprehensive long-term succession planning process."

As an alternative to the old rolodex pattern of board members recruiting and electing the people they know, more boards are beginning to align strategy with board composition. According to Julie Daum, North American Board Practice Leader at Spencer Stuart, "There is a much greater spotlight on board composition, on what skills are on the board, and whether they are relevant to the company strategy now and going forward. They have to ask themselves 'do we have the right people in the room?'" Daum observed "people feel it is important not to have all longstanding directors. There is a desire to have turn-over in the board room, and a desire to have boards really assess their own performance, and assess the performance of individual directors."

Katie Lahey, Executive Chairman at Korn Ferry, Australasia said "Boards have possibly changed more during the past decade than in the two decades prior." In addition to greater transparency and stricter governance rules, Lahey says "community expectations have also had an impact." She observed "Board composition has changed somewhat – but boards are still not nearly diverse enough."

Much is said about technology, disruption, and how boards have a role, with the executive team, in preparing for transformative products, services or processes. But "disruption" isn't strictly a business activity. Jo Baxter, Associate Partner at Hobson Leavy, Auckland explained it this way: "To quote Bill Gates, "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten. Don't let yourself be lulled into inaction." She said "For example, more and more business leaders in New Zealand are focusing on climate change as the number one risk coming down the line. For example, they are starting to underweight bank stocks on their portfolios with high exposure to residential property, due to global sea levels rising and the increased frequency and severity of major storm events."

A major event in Japan, where boards are likely to be traditional and comprised of inside directors, is the Japan Corporate Governance Code, which in 2015 introduced several major changes to the way boards of publicly traded companies in Japan operate. The Code focuses on the appointment of external non-executive directors, and evaluating board effectiveness.

Nobuyuki Tsuji is a member of Spencer Stuart's board practice, and leads the firm's Japan business. He explained "Shareholders from outside Japan were asking for more transparent board governance. Based on that, the Japanese government established the Corporate Governance Code, which requires a more transparent way of running the board, with improved communication, more external board members, and board assessment and evaluation. Shareholders specifically asked to have more non-Japanese external board members."

The changes we see on corporate boards also affect the individual directors. Susanne Thorning-Lund, Board Partner at Odgers Berndston in London said "Non-executive directors are becoming more engaged with the business. Increasingly you have board members taking a mentor role with a member of the executive team, and in global businesses non-executives are encouraged to attend regional executive boards, to deepen their on-the-ground appreciation of the business and of the leadership talent. In general terms Boards are taking a deeper interest in their businesses; this isn't just governance box-ticking," she said.

Kevin Jurd, Boards and CEO Succession Practice Leader for Australasia at Spencer Stuart, addressed a new reality for individual directors. In the context of "big corporate collapses where Boards have been held accountable, it becomes hard for those Directors to join another board after that." He added "Personal reputational risk is now being considered more intensely, especially in early start-up years for new directors. It can define their non-executive director career, and cut it short quickly."

The Drivers of Change

Regulation, disruption, social pressure and business needs are driving much of the change seen in recent years. "In Australia, for example, there is market and stock exchange pressure for transparency and gender diversity on boards and in management," Marks said. Thorning-Lund added "In the UK there is a lot of political interest in board governance at the moment, caused by failings at some high-profile companies. There's been a backlash. For example, the conversation now is about wider stakeholder representation on boards."

"Regulatory uncertainty and a lot of disruption and transformation are really affecting every industry," O'Brien said. "For example, when clients want to add digital competency to the board, it's often because their business has been disrupted and they need to have folks on the board who can think through those issues." Marks said "Boards are under increasing pressure to deliver results. There is pressure on boards now for performance—company performance. Boards have to have a certain amount of accountability around that, as well, because they select the CEO."

Lahey described an example of an organization using its influence on boards to drive positive change. She said "The Australian Council of Superannuation Investors recently said it will instruct its members to vote against the appointment of directors who sit on an all-male board." She said "There is certainly a brighter spotlight on boards now than in previous years and this has served to encourage boards to be more transparent and to be more attuned to broader community concerns. Culture is a very important topic for boards, and they are focused on ensuring that the organization has a culture that is aligned to business strategy."

In New Zealand, explained Baxter, "It was announced from October this year every NZ stock exchange listed company will have to have a diversity policy (or explain why not) in their annual reports. Publicly listed companies will be expected to establish a diversity policy with measurable objectives, and each year assess their progress against these objectives." She said "It's a pretty encouraging policy that recommends companies make their diversity policy and objectives public. It's not saying you have to achieve a certain level, but rather that you must measure and report on what you have."

Board Tenure and Succession:

According to Spencer Stuart's 2016 Board Index, "nearly half of board members believe length of tenure does not affect board autonomy." Which is telling, since board tenures in the US, at least, are getting longer, not shorter.

Daum said "US Boards have been getting longer and longer tenured, and people are cognizant that not everybody ages to 75 the same, and not everybody's experience ages the same way, either." She said "a lot of industries are changing very quickly, so if you were involved in that industry 20 years ago, some of what you know may be relevant but a lot of it may not be. A big part of the desire to have turnover is to make sure you have relevant and current experience."

Burgess sees the same trend. "The average retirement age is moving up – 75 is the new 72. It's funny that's happening, when there's been an outcry for refreshment on boards. The average board tenure continues to lengthen and increasing the retirement age only helps reinforce this trend." Acknowledging that some board directors may have outdated skills, Burgess looks at board tenure another way. “There are also people who’ve been on a board for a long time and continue to be great contributors and possess substantive institutional memory. You can’t rely on length of service and you can’t rely on age to determine when it is time for a director to step down. What you should rely on is their performance and ability to contribute.”

Sounds reasonable. “If you’re not doing well, it may be time to move on,” Marks suggested. Then again “One of the more difficult decisions for a group to make, even for people who make difficult decisions their entire careers, often, is saying goodbye to a director who is not working out. It is more usually done around the time of re-election,” he said.

Rotating out long-serving board members can be harder in regions without a deep bench of board talent. Speaking of New Zealand, Baxter said “We’re a small country, so there’s your top pocket of directors who are at the biggest publicly traded companies and tend to be well sought-after. Then there’s the middle ground, the ones on smaller organizations’ boards. You probably have this everywhere - the well sought out directors are extremely busy, and they’re not necessarily the ones you want moving off the seats. It certainly is a challenge.”

Another challenge Baxter highlights is that the slow pace of board retirement is limiting the opportunities for board diversification. “There’s a view that there is a proportion of senior directors who aren’t moving on – the seats aren’t being made available for the diversity to occur. There’s a degree of frustration around that.” She said “The forward-thinking boards seem to be stronger at rotating their directors. In our experience, the governance capability exists, and increasingly experienced executives are being given the opportunity to step into professional governance careers.”

In the UK, the accepted corporate governance best practice limits executive tenure to three terms of three years each: “the nine-year rule” according to Thorning-Lund. “What we are seeing are boards much more proactively engaged around succession planning for board members, analyzing board composition with a view to where the business is going, and therefore the skills they may wish to bring onto the board. This is also reflected in the broader diversity discussion. If succession is thought about in such a proactive way it raises the questions of where else could we go, what else could we get, and what exactly do we want? Those two things do feed quite nicely off each other.”

There is an outstanding question as to whether Next Gen board members will be interested in the long-term service preferred by their predecessors. Jurd observes “Some digital savvy, “new age” directors with startup experience will not be interested in committing to a 6-9 year term, so we may see greater rotation on boards.”

Governance and Board Committees:

Government regulations and stock exchange rule changes, primarily the result of the global financial crisis, other perceived risks, and investor pressure, are having a significant impact on board governance, globally.

Debate swirls around the issue of board independence. For example, whether the CEO and Chairman roles should be separated, and whether board chairs need to be independent. In some regions boards have few, if any outside directors, and in others, boards are mostly comprised of non-executive directors.

Japan is a key example of how investors seek to make significant changes to board governance. Tsuji explained, “Shareholders from outside Japan were asking for a more transparent board, and more transparent governance. Based on that, the Japanese government established the Corporate Governance Code, which requires a more transparent way of running the board, with more communication, and external board members. Shareholders asked to have more non-Japanese external board members to represent their interests.” The Code also encourages gender diversity on the boards of publicly traded companies.

Relatively new laws expose corporate boards in Australia to significant investor influence. According to the *Financial Times,* the ‘Two Strike’ rule refers to a 2011 law stating “if more than a quarter of shareholder votes are cast against a company’s remuneration report for two years in a row, it triggers a further vote – on a straight majority—requiring all directors to face reelection.” Jurd says “The ‘Two Strikes’ rule on remuneration is becoming the touch-point for activists to use to seek some sort of change to a board.”

This level of investor influence is complicated. “You have activist investors and their institutional investor supporters holding directors increasingly accountable and requiring directors to dedicate more time and effort into addressing activists’ myriad demands. Some activists have good intentions and some don’t – some want to take advantage of situations. Some activists are short-term oriented and others are long-term oriented.” Burgess explained: “The activist movement is not a fad. It is here to stay and will continue to grow and impact more and more companies.”

In addition, in several countries more corporate boards are addressing uniquely 21st century challenges through their committee structure.

In Marks’ experience, “I don’t see a particular change around core committees, but I do see them being more rigorous and effective in what they do, and more accountable. The skills that are required to chair them are increasingly complex.”

However, the nature of risk is evolving. Daum explained “financial service boards have added risk committees, and some are adding technology. Cyber security is something boards are dealing with, but we don’t find a lot of boards looking specifically for an expert in this area to serve on the board or on cyber committees.”

Burgess agreed. “We are seeing risk committees, once only the bastion of banks and financial services companies, popping up more often outside financial services.” He said “Cyber risk oversight on average falls under the umbrella of the audit committee. Stand-alone risk committees will become the norm as the oversight of risks such as cyber risk cannot be the responsibility of the audit committee, which already has its hands full with its existing mandates.”

According to the 2017 Spencer Stuart Board Survey, “20% of respondents reported having a committee dedicated to providing oversight of cyber/Iot risk, and nearly half (45%) said they rely on their risk or audit committee’s expertise in this matter. The remaining 35% choose to discuss and analyze cyber risk at the full-board level.”

Lahey said “We are seeing boards evolving in line with changes to the business and community environments. For example, we are seeing more demand for directors with technology expertise in Australia." She added "Board governance has changed in step with the changes in business specifically, and society at large." She said, for example, "ten years ago all boards had audit committees but now many have a separate remuneration committee, a risk committee and a sustainability committee. With greater transparency, there is heightened accountability - boards are certainly attuned to reputational and culture risk."

Baxter observed "there's a view that boards need to recognize the broader part that their organizations play in society – a much more integrated model that puts people at the center. It's really about broader trust. We're seeing boards taking their corporate social responsibility extremely seriously, and taking a wide, broad view of their and the organization's role in society."

The impact of these changes could be immensely positive. O'Brien said "Businesses that are successful are constantly having to rethink their business model or at least check that their business model is right. I would anticipate that the board will have a much bigger role in engaging with management around strategy. It will be less of an arms-length approach and more engagement."

Burgess added "If you do it right you have a governance body, that's a given, but you also have a group of value added, strategic discussion partners—a valuable resource and sounding board for management."

About board composition, representation and inclusion.

> *AESC members value diverse leadership. They identify the most qualified talent by searching and assessing without bias.*
>
> AESC Code of Professional Practice

What does good corporate governance look like, amid the uncertainty created by the economic slowdown in China, political events in the US and Europe, and the humanitarian and environmental crises we see around us? Many would argue that good boards look sharp. They have a breadth of skills and experience to draw upon and the ability to adapt, to see opportunities, and to make decisions from a broad range of perspectives. AESC's *Board Search and Advisory Guiding Principles* states "We, as a profession, believe that diverse boards are better boards and that diversity enhances business results and drives innovation. We are and will continue to be part of a broader solution to enhance diversity of board and business leadership."

High-performing boards know that diversity is a business imperative. O'Brien cited some simple facts about the impact of women on boards: "the effectiveness of boards greatly improved where there was greater gender diversity. Women serving on boards tended to be extremely well-prepared, showed a lot of EQ in the boardroom, and effectively altered the dynamic in a very positive way. So institutional investors are pressing the case for gender diversity." O'Brien's clients certainly are. "There is not one board that we are working with, where diversity is not a major goal."

"The diversity debate in the UK has been pretty strong over the last 5-6 years," according to Thorning-Lund, "starting with gender diversity and moving inevitably on to much broader diversity – what we at Odgers would call cognitive diversity."

She said “absolutely boards are keen to bring in a broader perspective. In a very fast changing and rapidly evolving world, boards are trying to keep pace with what is going on. Having breadth of diversity of perspective is perceived, rightly so, as very important.”

Yet in many cases board diversity is still more aspirational than real. In her keynote address at the Corporate Governance Network Annual Conference in June 2016, US Securities and Exchange Commission Chair Mary Jo White said “minority directors on the boards of top 200 companies on the S&P 500 have stagnated at 15% in the last several years.” She also said of the pace at which women are joining boards, “at the current rate of growth, the [US Government Accountability Office] estimated it could take more than 40 years for women’s representation on boards to be on par with men’s.”

In the US, boards are coming under increasing pressure to improve their gender diversity. As Daum explained “Part of the pressure is from institutional shareholders who are frustrated by the slow pace of change in the boardroom, even though the evidence points to the fact that diverse boards perform better. There is pressure from the shareholders to show change, to show they are thinking about board composition, and show that they have the right people in the room. Shareholders are saying “these people represent us, and we want the best people looking out for our interests.” “

Thorning-Lund said “In the UK there is more of a focus on developing future potential board members, the pipeline, particularly with the political interest in this subject.” Referencing the Hampton-Alexander Review, a government effort to improve representation of women on FTSE 350 boards and amongst the C-suite, she said “it is all about the next generation of leaders coming through. The big emphasis has been on gender diversity, and is expanding into race and ethnicity.”

In New Zealand, 40% of listed companies already have 25% or more female representation at the board level. Baxter said “In our State sector boards, they’ve reached an all-time high of 45.3% of women participation. It’s very encouraging that the index has come out to drive change and encourage diversity and inclusion. And part of this is this new diversity framework: if you can measure something, you get ahead.”

Finding female executives to become board members in Japan is more challenging, according to Tsuji. “Not enough women rise up through companies” to gain the business experience needed to serve on a board of directors. He added “only 4.5% of directors in the Nikkei 225 are female, and many of them are lawyers. (source: 2016 Japan Board Index)”

With very few female executives to draw from, improving gender diversity on boards is a challenge. Tsuji explained “In Japan there is a shortage of supporting infrastructure for female executives, such as nursery schools and kindergartens, which makes it hard for a mother to continue working if she has children.” He said some companies are starting to address the environmental barriers to women advancing in the workplace. “Some companies are working hard to increase the number of female executives. They are establishing nurseries inside the company, so mothers can continue working.”

He added “the companies who do that will eventually have more female executives.”

In O’Brien’s practice, “We are also seeing a demand for digital capability – people who can think in terms of how their businesses are being transformed by digital technology. It’s about someone who can ask the right questions, and make the right investment decisions.”

In Burgess's view there is a demand for board members who have experience with new technologies: "Disruptive technologies, digitization, IoT, big data, and data analytics are going to have a substantial impact on most every company. Our clients want people with relevant and real-time technological experience and expertise," he said, "but clients often approach us with a lingering concern. We're talking about people who are much younger than we are used to having on the board. The relevance of potential board members with tech experience is incredible, considering the types of technology companies want to embrace, but do these young board prospects have broad enough experience/bandwidth and perspective to be sufficiently well-rounded and seasoned enough to be truly effective directors?"

While not geared specifically to young board prospects, New Zealand's "Future Directors" program is improving the pipeline of experienced board candidates. Jo Baxter described "The Future Directors program: a forward-thinking initiative set up in 2013 to help otherwise qualified executives gain experience in governance and to provide boards with increased diversity of thinking, currency of skillsets and a broader pool of potential candidates."

Through this initiative, 'future directors' participate as a member of a board of a New Zealand company for one year and gain valuable experience. Baxter explained that it is a very active role. "They must contribute to all meetings, and by all intents they act as a director however they do not have voting rights." She said "It gives people who have never had governance experience the chance participate at a Board table."

Over two dozen directors have completed the one-year commitment since 2013. The expectation is that they will go on to have board directorships following the program.

Board Assessment and Effectiveness:

Shareholders globally are demanding transparency and accountability, and organizations are increasingly making commitments to evaluate the performance of boards and in many cases, individual directors.

"It is standard practice in the UK, for example, that companies, boards engage in an effectiveness review every 3 years" O'Brien said. "We are seeing more of that in the states in recent years, and part of that is being driven by the recognition that boards are being held accountable to a degree that they weren't, before, and they have to make sure they are performing at the highest possible level. You have a lot of pressure from institutional investors, and that will be a growing pressure."

How do organizations identify effectiveness? Marks said "Different stakeholders have different views of how effective a board is. It's something more and more boards do. Some boards do it through internal process, others get assistance from a third party." Honest self-reflection isn't always an easy exercise under any circumstances some, but Marks's said "It's easier if they have an open, transparent culture. And it is the hallmark of a good chair, who is open to doing that as well."

Assessing board effectiveness is a new (2015) requirement of the Corporate Governance Code in Japan, where, according to Tsuji, "The measure of Board effectiveness was not well-developed yet." He explains that any assessment was an internal matter for Japan's boards, "but the Code requires companies to evaluate and assess board effectiveness, and for most companies, they are just starting."

Whether the increased attention on board assessment and evaluation will have an impact on future board performance remains to be seen, but another element of board assessment is related to alignment: the inventory-taking of skills and experience and making sure the board has what it needs to perform its responsibilities.

Changing Practices in Board Search and Advisory Services

If it affects the client, it affects the advisor. Firms and consultants who are involved in board work see their practices changing, as the priorities and needs of their clients change.

"Five to ten years ago, if there was some big CEO transition, the company would bring in half a dozen folks to make a pitch, and somebody would win the mandate and go find new CEO," O'Brien recalled. Today, "Because of the requirements around long-term CEO succession planning, boards have taken on thinking about succession – so we get called in 2, 3, or 4 years ahead."

To meet the changing needs of board clients, Russell Reynolds "created a separate group called the Board and CEO Advisory Group." O'Brien said "We noticed that a lot of our work had expanded beyond conventional director search, and we reorganized ourselves to address that need."

Tsuji described the traditional method of board member recruitment in Japan. "Especially in large corporations, CEOs and chairman have their own personal networks of executives in the community, and they invite the external directors for themselves."

With the new rules requiring outside board members, qualified directors who are not already engaged on a board are becoming harder to find. "Some companies in Japan, because of the huge demand for non-executive directors, are more and more using search," Tsuji said. "Some clients ask specifically for female board member candidates. We have a good network amongst female executives, and we always keep developing the list of females for potential board assignments."

For Burgess, it's a different kind of change. "What is affecting us is the increasing level of granularity in directors' profiles that clients are providing us with." Burgess described the shift from having less direction and guidance from clients to receiving a highly robust and well-thought out candidate profile. "It's given us clearer marching orders, but some of the lanes we now have to go down may be narrower. The specificity is good, but it can also be challenging, because the population you're now going after might be smaller. In some instances the pendulum has swung too far in favor of granularity."

What we hear globally is that board member succession carries high stakes, and interested candidates who possess the right mix of qualities are hard to find. That isn't likely to change.

Imagining the boards of the future

What next? We invited several board search and advisory experts to speculate on what board of directors will look like in 2025.

Board terms

- **Shorter**. Longer careers, later retirements, and limited term limits worldwide notwithstanding, board tenure will be shorter, because of the growing emphasis on refreshment. What it means to be on a board will change, and the expectation of semi-permanence will change, too.

  "We need to think of the board of directors more as a group where there is constant refreshment and directors coming in and out: as the board looks for new expertise, and as people say "I think I've done everything I can here, it's time to move on.' It will be much more dynamic." Julie Daum

- **Deliberate.** Boards are taking succession from reactive to strategic. No more drag & drop, boards will be balancing skills, building diversity, and creating a successful team based on the company strategy.

  "Boards are thinking much more proactively around succession planning of board members, where the business is going and any headwinds (such as cyber risk exposure, and the rise of the digitally savvy millennial generation as a consumer group), and the related skills they may wish to bring onto the board. This feeds into the broader cognitive diversity question. … as you think about succession planning in a proactive way, you will want to address the question of where else could you go, and what exactly do you want." Susanne Thorning-Lund

Composition:

- **Diverse.** The business case for diversity has been around, studied and measured, for a long time. It's hard to say why organizations aren't farther along, though some parts of the world are doing significantly better than others. If public outcry doesn't demand it, the drive to be competitive may.

  "Boards will certainly be a lot more diverse in the future, and diverse in every sense: gender, race, age, sector, background, competencies and global perspective. There is one thing for certain, you will not see boards that are solely made up of men aged 55 to 75." Jo Baxter

- **Younger.** It's not simply that baby boomers are retiring and their places in businesses and boards are transitioning to the next generation. Shareholders and business leaders are recognizing the value of a younger perspective, and demanding it.

  "We'll see a continued, if not increased, demand for digital or technology-related experience on the board, especially since most companies are on some sort of technological journey (e.g. Industry 4.0), and this will also result in increasing numbers of younger directors populating boards. It will be interesting to see how this youth movement impacts board dynamics and board culture" Carter Burgess

Trends:

- **Relevant.** Boards are becoming more than a governance body, and directors are increasingly required to contribute meaningfully to strategy, and engage in decision-making with perspectives that are relevant and connected to business realities.

> “Disruptors such as digital technology, global events or government policies quickly impact our market and I think we will see boards that are closely engaged with the strategy and non-executive directors with deep and specific knowledge in the areas that present the most risk.” Katie Lahey

- **Engaged.** Boards traditionally keep some distance from the companies they serve, but passive non-executive board directors may become fewer, as the levels of transparency, public scrutiny, and accountability continue to rise.

  “Sitting on a board is now an active engagement for senior executives who retire early and choose to develop a board portfolio for the next 10-15 years of their careers. They’re better prepared, read the Board papers and make this their priority.” Kevin Jurd

CONCLUSION

> “When considering how boards will be different, we should first consider how companies will be different in 2025 than today. Good boards reflect the evolution of the company, the sector and the broader business environment.”
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> Katie Lahey

What comes to mind when most people think about boards of directors? Most likely the image includes a lot of men who have been together a long time, in a stale room, behind a closed door. But the world is changing, and companies—and the boards that serve them—are changing, too. With increasing transparency, a growing appreciation for the competitive advantage of diverse perspectives, and a rising degree of engagement from non-executive directors, boards are becoming more open, diverse and agile.