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Teneo Insights

The High Performance Board in Today's Climate

A deep-dive into the most pressing issues boards will contend with over the next 12 months.

A discussion between Megan Shattuck and Patricia Lenkov, senior members of Teneo's Talent advisory offering. Moderated by Kevin Kajiwara.

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Kevin Kajiwara (KK): I'm Kevin Kajiwara, Co-President of Teneo's Political Risk Advisory Practice. Today we are here to discuss the top challenges facing boards today – and what these issues mean for not only the process of recruiting directors, but also board performance and effectiveness. To kick off the call, Megan, what does a high-performance board look like today? How do you know if you have one?

Megan Shattuck (MS): Thanks Kevin, and thanks all for joining us today. Patricia and I will be talking about issues that are top of mind for boards today, with a focus on board performance, and what the implications are for director talent.

So, to start with your question, 'What does a high-performance board look like?'

It goes without saying that every board has its own dynamic. We are talking about a group of leaders who bring their own experiences, personalities and capacity. It may sound obvious to say, but we are talking about human beings, and the boardroom is very human. So, it is extremely important to have the right kind of leadership "leading leaders" to activate best-in-class governance, in addition to the right kind of process that makes room for continuous improvement on a board. And in today's environment, these factors are even more crucial because the role of the director is even more demanding and time-consuming, and more eyes are on performance.

At the most basic level, a healthy board is one that functions well as a team and communicates well. It includes a diversity of views and experiences in alignment with the business strategy. The board helps the CEO lead effectively. When a company has a great board of directors, good results are more likely to follow.

While that sounds simple, operationalizing boards to spend more time on forward-looking issues in the context of a complex operating environment, with dynamic and volatile markets, is not simple. As the operating environment has evolved, expectations with regard to corporate governance have also evolved across board composition, governance structures, appropriate compensation, risk oversight the importance of diversity on boards, and ongoing engagement.

So, what does that mean for directors and board performance? We see the contributions of individual directors - and the effectiveness of the board as a team - taking on greater importance, with an increased spotlight on individual directors and board performance that goes beyond "just"

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the connection to corporate profit and shareholder gain. And this dynamic is changing the expectations directors have for themselves, in addition to the expectations of investors, proxy advisors and even employees.

When we think about all that the board has to manage: choosing the CEO, monitoring the performance of the CEO, a CEO succession planning process that is ongoing, determining executive compensation and incentive structures, understanding investor and proxy advisor views on comp, oversight of risk management – in addition to managing “newer” priorities across ESG, sustainability, corporate culture and beyond – this has created an incredibly dynamic environment for boards to navigate – and a very time-consuming one.

What helps? The right team on the field. With the right board composition, a constructive environment is created where management and the board itself is engaged and challenged on critical topics across business issues, risk, culture, innovation, environmental sustainability, CEO succession planning and board succession planning. But how do you ensure you have the right people? And how do you ensure the board is performing?

It’s been over a decade since the New York Stock Exchange decided to require boards of directors and key committees to conduct board evaluations. While well intentioned, we hear from many directors who do not find annual board and committee self-evaluations particularly helpful. While board assessments are standard, individual assessments are relatively rare.Mandatory retirement still seems to be the key mechanism for turnover. Our view is looking at average tenure is a good way to assess when change might be needed.

While board refreshment, the consideration of expertise and skill sets needed, and the importance of diversity are not new priorities, the group of stakeholders who are now more carefully scrutinizing these attributes is a large one: investors, consumers and customers are watching, and increasingly, employees.

What is new, is an amplified conversation and a brighter light on board performance in the context of the classic governance paradigm: management is accountable to the board and the board is accountable to shareholders. Given this, how should a board assess its own performance? And what makes that assessment meaningful?

To go from “check-the-box” to “best practice” it is our belief three ingredients are crucial:

- The right leaders: the lead independent director and the chairs of all the committees need to not only meet expectations for experience, they need to be able to spend the time and want to invest in the relationships, and also be willing to have those not always comfortable, but very important difficult conversations.

- Holistic assessment of board performance should be conducted in close consideration with the nature of corporate governance, risk oversight, board culture, corporate culture, and of course the relationship of the CEO with fellow directors and vice versa.

- Board - CEO relationship: This means the board helping and challenging the CEO in a constructive manner that is good for the company.

When board performance is assessed on an ongoing basis, with the right leaders in place, and it is conducted in a holistic manner, the board is in a stronger position to preempt threats and create long-term value.

The best offense is a good defense. I call this “future-proofing,” for not only board performance, but for corporate performance.

KK: Patricia, are boards currently focused on the right risks? What are some of the newer risks that boards need to think about?

Patricia Lenkov (PL): As we know, investors, regulators and other stakeholders are very interested in risk. And while risk has been on the agenda in boardrooms for a while, the types of risks that companies must contend with are changing. Boards must stay current on new and potential risks facing their company, their industry, their employees and even the geographies they are in.

Additionally, transparency is increasingly important; boards must communicate their approach to risk oversight. And it is important to distinguish between oversight of risk, versus risk management: boards do not get involved in day-to-day risk management – rather they must have oversight – they must insure that risk management practices and procedures are in line with company strategy and risk appetite. And it’s important to note that the SEC requires companies to disclose the board’s role in risk oversight.

We don’t have time to cover all the risk concerns of boards (there are too many), but some of the newer risks that boards must be thinking about include:

- Cyber security, which is still an issue on every business leader’s mind. What is particularly challenging about this business risk is that cyber criminals are getting bolder and tactics are always changing. From the board’s perspective, company leadership needs to stay extremely current with some of these new cyber security threats, which may include issues such as: crypto-jacking, which is the unauthorized use of someone else’s computer to mine cryptocurrency; software subversion, which are efforts to actively subvert software development processes; and attacks to a cryptocurrency ecosystem, where we will continue to see a related rise in attacks against individuals and organizations who use cryptocurrency as an increasingly standard element of their business operations and transaction options. In response to these threats, we are starting to see some ‘Chief Cybercrime Officer’ titles. Boards must understand these new risks, and their solutions must be ever-evolving. And it is imperative that boards understand not only cyber risks, but technology changes in general, and the impact and potential risk they may have on businesses. MIT recently did some research and showed that of 1,233 publicly-traded companies with revenues over $1 billion, 24 percent had board members that were classified as technology experts (CIO or CTO), and this research also showed that these companies outperformed on revenue growth, return on assets and market capitalization.

- Talent risk is another type of risk that is becoming more of a concern. Risk monitoring reports indicate that talent shortages are of major concern to all types of companies. Organizations face huge challenges from the pace of business change and the digitization of their industries. Risk managers must work with HR managers to develop approaches and strategies to deal with this. The American Institute of CPAs did some research and recently found that 48 percent of CFOs said they are "mostly" or "extensively" concerned about their organization's ability to manage leadership and talent needs. Perhaps this is one of the reasons we have seen a three-fold increase over the past decade in CHROs and other top HR executives with positions on U.S. corporate boards. According to Equilar, in 2005, there were 84 HR executives on U.S. public company boards, and in 2017 there were 243; this is a trend that I believe will continue. For example, last year, Tesla appointed Kathleen Wilson-Thompson, Executive Vice President and Global Chief Human Resources Officer of Walgreens Boots Alliance, to its board. This type of expertise on boards will continue to be in demand and can also be helpful with say-on-pay issues, as well as complex compensation package challenges.

- #MeToo risk is another reason boards may want to consider HR expertise. Companies leave themselves open to legal action by not having the proper HR procedures in place. And this risk needs to be discussed beyond the HR department and should include the board. Last year, I wrote an article for MIT's Sloan Management Review, "Bringing Lessons From #MeToo To the Boardroom." In the article, I stated that boards need to be proactive in shaping a corporate culture that does not tolerate sexual harassment. Whether you are a member of the board of a public, private, or nonprofit company, procedures for addressing and preventing sexual harassment must be on your board's agenda; directors need to do the right thing for employees, for customers, and for all stakeholders. This is a risk we would not have spoken much about even five years ago.

KK: We have come a long way from the days of corporate raiders depicted in movies like "Wall Street," - today's generation are called "activist investors" or some of them like to be called "constructivists." Even this new crop of investors has been evolving. So, what's going on with activists these days? What should boards be thinking about?

PL: Activism of all types is about driving change. Shareholder activism has received a lot of attention in the last five years, but it has in fact been around for decades. And we can be fairly certain that shareholder activism is here to stay. Shareholder activism comes about when there is the perception that management is not maximizing the value of the company they are charged with running on behalf of shareholders. Shareholder activists want to engage with the companies they invest in and typically they focus on issues such as: executive compensation; governance policies and board composition; the company's strategy; or M&A activity – either with the idea to encourage some division to be spun-off or sold, or alternatively, to prevent M&A activity.

And there are many new and emerging trends I see, relating to activist investing which I will touch upon.

The first, is that the lines are blurring about who is an activist (and who is not). Traditionally, passive investors can turn activist in certain situations. Long-term institutional investors who previously never would have considered themselves "activists" are getting into the fray. Some are approaching hedge funds with a specific target in mind, backed by their own research, to suggest teaming up. Others are turning into "occasional activists" in their own right, without a hedge fund partner. For example, Vanguard, State Street and Blackrock have certainly been more vocal about what they expect from the companies they invest in. They have also bolstered their shareholder engagement teams. Also, some PE firms are raising funds for activist investing. For example, in 2018, Waterton Capital used an activist investor technique with HudBay Minerals and pushed for a new slate of directors after accusing the board of mismanagement.

On the other side of this, you have traditional activists behaving like PE firms; earlier this year, Elliott Management asked its investors for $2 billion to take companies private, and this is in addition to its already established PE arm, Evergreen Coast Capital.

So, the net net of all of this is that investors can morph and change, and there are likely new activists on the horizon that we have never heard of, so it's incumbent on boards to stay on top of these developments and prepare accordingly.

Second amongst these trends, is that there were less proxy contests in 2018 than previously. Lazard reported that activists won a record number of board seats (over 160) in 2018, up more than 50 percent from 2017 and only 22 percent of board seats won were through a proxy contest. These days, companies prefer to grant activists a board seat (or two) to avoid the public distractions of a timely and costly proxy contest. Companies are savvier about activists than ever before and realize that the old method of circling the wagons and keeping the activist out does not work.

Third, is the greater focus on operational activism, which has more of a long-term focus. Activists join the board (or appoint independent directors), replace members of management and help execute a new strategy. While many hedge funds had been thought of as being too focused on short-term gains, the longer-term operational activism has helped to shift that perception.

In summation, not all activists are created equal - they have different tactics, different motivation and are of different levels of quality in terms of the work that they do. So, companies need to understand the current landscape and be prepared; don't wait to receive the phone call or the letter to consider how activists might perceive your board and your company – prepare and get ahead of the situation. Activism is an acknowledged and recognized investment strategy and therefore cannot be viewed as some rogue activity. As such, it needs to be dealt with in a thoughtful and professional fashion.

KK: So, Megan, if being prepared is key, what are ways the board can be prepared?

MS: Shareholders focusing on the makeup of the board is not a new thing. Composition, skills and diversity as priorities for investors are not new things. What we are seeing in general as it relates to skills and experience is investors are becoming more vocal with their expectations of boards to proactively drive a process that identifies gaps in skills and experience, and then present a feasible approach to deal with those gaps.

What we are also seeing is more of a spotlight on forward-leaning skills and experience, in alignment with the business strategy. For example, BlackRock recently stated in its most recent proxy voting guidelines: "We encourage boards to disclose their views on the mix of competencies, experience, and other qualities required to effectively oversee and guide management in light of the stated long-term strategy of the company." Another example is Vanguard, asking questions like: "Based on your company's strategy, what skills and experience are most critical for board members, now and in the future? How does the board plan for evolution and future director selection (that is, for strategic board evolution)?" As a result, we are starting to see boards share more information in proxy statements and on company websites about how the nominating and governance committee runs its process, and how directors align with the business strategy.

We also know that boards may be criticized for having similar board members, with similar backgrounds, education and networks. Such homogeneity among directors is more likely to produce 'group-think.' So, nominating and governance committees that "refresh" the board's needs every two to three years are in a much stronger position to "future-proof." This also helps to move the board away from directors looking at board appointments as "lifetime appointments" and guards refreshment as a process.

Experience as a CEO or on a public company board has historically been a must-have credential – and it is still a big one, even though one third of the new S&P 500 director class in 2018 was serving on their first public company board.

The SEC adopted rules requiring boards to disclose whether the audit committee includes at least one financial expert. Requirements for companies to have a compensation and nominating committee are important, but they are not focused on evolving skillsets that are considered to be "softer" attributes.

Although the climate we live in constantly evolves, the matrix in the boardroom remains quite consistent with traditional skillsets such as leadership, financial, industry, and CEO experience. Skills such as risk management, marketing, legal background, and human resources have not shown great gains – although we are starting to see more asks about different types of experience. Some of the newer areas we are seeing in the board matrix include:

- The evolution of the "digital director" to the technology expert: in addition to cyber, this person may be current on big data, privacy, artificial intelligence, emerging technologies, and has a point of view on how best to leverage risk reports. As Patricia shared earlier, MIT showed that of 1,233 publicly-traded companies with revenues over $1 billion, 24 percent had board members that were classified as technology experts (CIO or CTO).

- Marketing experts who understand how to find, reach and sell to consumers everywhere and how to best leverage consumer data.

- Human capital and talent experts: Professionals that are talent and recruiting experts and who also have backgrounds in HR, as we mentioned earlier.

KK: Diversity in the boardroom: hasn't this issue been discussed for a long time? Where are we on this? Any new developments boards need to be aware of?

PL: Diversity in the boardroom remains a "hot" topic. What has changed over the years is how we define diversity on boards. Diversity has a multifaceted definition that includes gender, ethnicity, age, geography and industry. In terms of what to focus on when it comes to board diversity, diversity of thought is key, and it must be inseparable from other qualifications.

Despite the years of focus on diversity, the change has been glacial. But here's the good news: as of January 2019, women and minorities make up 34 percent of board seats in the Fortune 500, which is an all-time high. For reference, this number was 30.8 percent in 2016.

The not so good news is that as companies get smaller in size, diversity on boards significantly drops. In 2018, the number of women on The Russell 100 index (not 1000) that sat on company boards was 25.3 percent. On The Russell 2001 to 3000, that number drops to 13 percent.

So, what do these stats mean?

As with many best practices, large corporations are generally the first to adopt them and we have seen this to be the case with diversity. But willingness and interest in diversity does not tell the full story; boards must have the available openings so that they can improve themselves.

And generally, there is still legacy thinking that board service is for a lifetime – in other words it is still harder to get people to come off boards. Board succession planning is still not as common as it should be and there is a cultural belief that if someone comes off of a board too soon, there is something wrong with their performance.

All of these things must change in order to improve diversity on boards.

What must also change is the long-held belief that there is a lack of supply of diverse candidates for boards. To illustrate this, we only have to go back to the Twitter IPO, which took place without a single woman on the board. After the outcry by various groups and media outlets, Twitter stated that being a very technical company meant that there were not many qualified technical women. Fast forward to today, and Twitter has three women on their board of nine directors.

The topic of diversity on the board cannot be discussed without talking about quotas that so many countries have adopted to push progress. There have been gender diversity quotas in Europe for the past 15 years: Norway was the first country to institute a quota for publicly-traded companies and many countries followed. Here in the U.S., this has always been very controversial, and in fact, most in governance and academic circles have long maintained that the U.S. would never resort to board quotas. However, California made headlines in September of 2018 with legislative action towards instituting gender quotas for boards. Governor Jerry Brown signed a bill which includes mandates that any public company that has principal executive offices in CA must have at least one woman on its board by December 2019, and by 2021, boards with five directors must have two women on the board, and boards with six or more directors must have three women on their board.

What many do not realize is that in 2013, well before the current bill, California passed Resolution 62, which urged that within three years, California companies increase representation of women on their boards; clearly simply encouraging companies was not enough. About 25 percent of the nearly 400 California-headquartered companies in the Russell 3000 stock index have no female directors, according to research cited by the legislation. And this matter is all very controversial still; why prioritize one form of diversity over another? Some argue this violates the constitution.

Illinois has a bill that requires public companies with headquarters in Illinois have at least one female, one African American, and one Latino on their boards. And if they fail to meet this quota, the penalty is fines of up to $100K.

Pennsylvania also has a similar bill and New Jersey has legislation like California's that has recently been introduced.

These quotas mean that many companies must change their boards over the coming years.
And the key to all of this is realizing that this is not simply a social good exercise, but in fact that diverse groups make better decisions, and that boards can get all of the skills, experience and expertise they need and a diverse director; these qualifications are not mutually exclusive.

KK: Succession planning in the boardroom: So, you know the skills you need, how do you make sure you have the right people on the board making the best decisions? What should boards be doing?

MS: Most boards do not have a well-articulated succession plan. The rapid pace of transformation and scrutiny from shareholders on composition and diversity means boards must develop immediate and long-term succession plans to align the board with the company's go-forward strategy/account for planned director departures.

And this goes beyond "recruitment;" it is an ongoing, integrated way of working that is not "reactive" or event driven. Some recent areas of focus within this topic include:

- Lead Director Succession Planning: We have been asked a number of times about how best to select the lead director. The process should be established by the nominating governance committee and approved by the full board. Developing the right criteria is the starting point. Choosing from the incumbent directors makes sense. The nominating governance committee should evaluate more than one candidate, and while the CEO should have some input, they shouldn't have the overriding decision.

- Committee Effectiveness and Succession Planning: This is an area where we see a lot more time spent, again, as a direct result of the time spent on board work, healthy and active committees are all the more important. Somewhat surprisingly, there are not a lot frameworks out there for assessing committee effectiveness and connecting that to succession planning.

- Availability: Serving as a director requires a tremendous amount of time. One illustrative example that I have observed is that we hear from people every day seeking a board role or who want help putting together their strategy for how to find the right board where they can add value. Over the past couple of years, I have had people say to me, "I only have time for one," or "I do not want to be on a public company board," or "While I want to say yes to this board, the geography is just not realistic given the demands of my 'day job'."

KK: Corporate Activism - another form of activism? Can you talk about what this means and provide perhaps some examples?

PL: Corporate Activism could be this generation of boards' (and corporations') largest challenge. There are a multitude of factors that have led us to a corporate world where employees are empowered to protest strategic decisions made by their employers. According to Wharton research, there has been a 75 percent increase since 2000 in the number of social movements targeting firms. The reasons for this include: a rise in socially conscious consumerism;

millennials who think about work in a whole new way; a strong economy where employees know their jobs are secure or they can find new ones; media/social media and the increased volume of it and the "tech-lash" companies are experiencing as a result.

A recent study from Povaddo found that 40 percent of U.S. employees at Fortune 1000 companies say a company's actions on societal issues impacts their decision to work there. And another 29 percent say they would be less likely to continue working for their company long-term if it made zero effort to make a difference on an important societal issue.

A current example of this phenomenon is Amazon, where employees recently sponsored a shareholder proposal asking the company to report on how it plans to reduce its reliance on fossil fuels and manage the risks posed by climate change. More than 7,600 employees have signed a letter calling on Jeff Bezos and the board to support the resolution. The letter included a request that Amazon stop offering its cloud services to the oil and gas industries.

And more than half of S&P 500 companies today have a board committee that is formally tasked with monitoring and advising on issues of social responsibility or environmental policy, compared to only 12 percent in 1990.

These changes and pressure represent opportunity - opportunity for corporations and boards to distinguish themselves and take a leadership role. Boards can choose to be proactive on these issues or can kick the can down the road.

Smart companies and their boards will be more proactive and even turn these challenges into opportunities that will create new benefits for their brands and reputations.

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