ESG Spotlight.

North America's board refreshment challenge

Contribution by Clare Payn – Head of Corporate Governance North America

Clare is Head of Corporate Governance North America at Legal & General Investment Management. Clare has overall responsibility for LGIM's ESG engagement and voting activities and policy setting in the North American region. She communicates with companies, investors, and other market participants in striving for best practice in the market.

Clare also leads the governance team's work on improving gender diversity on corporate boards. She sits on L&G Group plc's Equality, Diversity and Inclusion Committee, which works towards creating an inclusive and diverse culture. She also sits on the Female Talent Forum, a committee focussed on strengthening the Group's female representation below Board and Executive level.

Clare joined LGIM in March 2010 from Aberdeen Asset Management and has 15 years' experience in corporate governance. Clare graduated from Loughborough University and holds a BA Hons degree in English Literature.

In the US, the board refreshment process is under scrutiny yet remains focused on retirement age limits. LGIM suggests a better way for US companies to refresh their boards.

Board term guidelines are scarce. Existing term limits are lengthy.

LGIM EXPECTS:

- The Lead Independent Director (LID) along with the Chair of the Nomination Committee to periodically review the independence, expertise and skills on the board in the context of the company's long term strategy.
- Companies to illustrate through disclosure how board tenure is actively managed and assessed.
- Companies to demonstrate a robust succession planning process including how potential directors are identified and on-boarded.
- Key board committee Chairs and the LID role to be held by directors who have not served on the board for an extended number of years.
- Companies to declassify their boards to allow for the annual election of directors.

Board refreshment and director succession planning are key board tasks and the foundations of a well-functioning board. A board should remain relevant and diverse in terms of perspective, experience and skill sets. This ensures that the board can respond to risks and opportunities in order to sustain profit growth, maximize long term returns and guide the company successfully into the future.

A long-tenured board can be an indication of a poorly managed succession planning process and a lack of refreshment of skills and perspectives which then calls into question the quality of its members and the effectiveness of the board as a whole.

> *"Only 3% of the S&P 500 specifies a term limit for directors, while the longest term limit is 20 years and the longest tenured director has served 48 years."*

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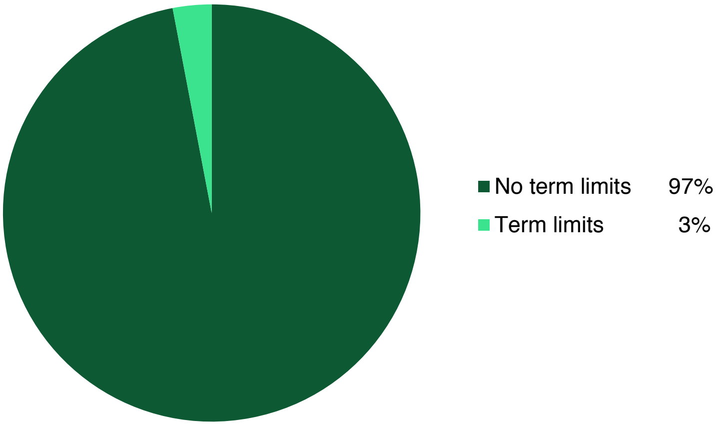
Figure 1: Director term limits in S&P 500



Source: LGIM

The longer tenure of a board director may also indicate a lack of independence from management. In the UK, for example, the independence of a non-executive director is re-assessed once they reach 9 years on the board and a company must explain after this period why it believes the director in question remains independent and still able to challenge. Such best practices have helped to lower average board tenure alongside strong independent board Chairs.

The mix of tenures and levels of experience on a board is fundamental and we do want long term experience on the board as corporate memory is vital to help the company navigate through cycles it may have seen before.

Longer tenured directors are not necessarily ineffective to serve on a board as experience is important, but LGIM would discourage such directors serving as a LID or as Chairs of key board committees where independence is essential. The independence of longer tenured directors should also be robustly re-assessed to ensure they remain independent with these assessments being disclosed to shareholders.

> *“A board should be comprised of approximately a third relatively new directors, a third mid-tenured and a third longer-tenured directors.”*

This balance would allow a company to utilize the experience of the longer tenured directors whilst limiting the risk of high director turnover over a short period. Aside from independence potentially being compromised, lengthy board tenure can stifle the board in terms of replacing key skill sets and perspectives, limiting the board’s ability to bring on new directors with relevant expertise. The world is dynamic and fast moving and boards need to be able to adapt to changes in technology, consumer trends and globalization and an active refreshment process and mix of tenures will provide newer experience.

The LID or Independent Chair should closely assess the independence, expertise and skills among the directors in the context of the company’s strategy. This is not a personal critique, but rather an honest assessment of what is in the long-term interests of the company. A LID who successfully manages board rotation out into the long term is able to more easily identify skill sets that may need to be replaced in future as he or she will be aware of and able to manage those directors rotating off the board.

> *“Over 100 companies in the S&P 500 have an “independent” board director who has served for 25 years or more.”*

As the LID actively engages in board refreshment planning they should take into account any tenure policies as well as input from board discussions and from the board and committee evaluation processes regarding the specific backgrounds, experiences and skills that will contribute to overall board effectiveness. Also considered should be the future needs of the board and its committees in light of the company’s current and future business strategy and the qualifications and skills of directors who are expected to retire and rotate off the board in the future. This simple and thoughtful process will enable the LID to identify director talent with the preferred skills and background required. As a final part of this process a robust director onboarding and training process will allow new directors to contribute quickly.

This process will help recruitment as the potential director knows in advance that they are signing up for a finite period and will also empower the LID or Independent Chair to ask a board member to not submit for re-election, taking strength of character which we would expect in such a role. To be able to have regular, open and honest conversations on board composition can aid both the LID and the director when it may be time for an individual to rotate off the board. This is why LGIM are such strong proponents of a formal external board evaluation process. See the Fundamentals publication on our website: http://www.lgim.com/uk/en/knowledge/fundamentals

LGIM considers the board evaluation process to be a positive exercise to help identify strengths and weaknesses of board composition which should be used to ensure successful board dynamics. This is a process designed not to reveal the shortcomings of board members but rather to help identify skills mismatches, expertise gaps and potential opportunities for succession and director training to help companies stay ahead of the curve.

> *"Retirement ages are not enough. Yet the use of these is increasing."*

It is common for companies in this market to have in place retirement age limits for directors. However, a company should have a more active refreshment process, as described here, not least as age limits are often extended once a director is approaching the set limit. Additionally, as demographics and lifestyles change, a director may join a board at a younger age and in today's world of people living longer, where a company has an age limit of 75 an individual could, under such a policy, be able to serve on a board for 25-35 years. There will be significant differences between different directors of the same age. It is often argued that companies do not want to lose the skill sets of a quality director who may be long tenured yet if succession and refreshment is being handled thoughtfully and appropriately, these skill sets and qualities will already have been identified in a replacement. A retirement age is simply a number and does not in fact allow or encourage the continual assessment of the ability, independence, or relevance of skills of a director.

Board refreshment is a key driver of a well-functioning board and it should be undertaken thoughtfully and regularly in order to create the best board and foster the understanding amongst its members that positions are not indefinite.

As LGIM engages on this topic with companies, our voting policy will evolve over time but as we look towards how we shall begin to vote on this issue in 2017 and beyond:

LGIM WILL VOTE AGAINST:

- The Chair of the Nomination Committee if the average tenure of the board is 15 years or more.
- The Chair of the Nomination Committee if there has not been any new board appointments for 5 years or more.
- Key board committee Chairs and/or the LID if they have been serving for 15 years or more.
