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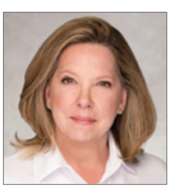
Board Composition, Diversity, and Refreshment

In her regular column on corporate governance issues, Holly Gregory discusses recent developments with respect to board composition, director diversity, and board refreshment mechanisms.



HOLLY J. GREGORY
PARTNER
SIDLEY AUSTIN LLP

Holly counsels clients on a full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory, and listing rule requirements, and governance best practice.

Board composition provides the starting point for establishing a strong and effective board. Significant attention has been given to the composition of public company boards due to Securities and Exchange Commission (SEC) disclosure requirements and stock exchange listing rules that require independent directors to take the lead on the nomination of directors and increased disclosure of director qualifications and the nominations process.

As independent directors and independent nominating committees have relied more on search firms and other advisors to help assess the board's compositional needs and identify appropriate candidates, management's influence on director selection has decreased. At the same time, the advent of majority voting in director elections and proxy access, and the significant rise in shareholder influence generally, has made decisions on board composition more susceptible to shareholder influence than in the past.

However, boards continue to be largely self-selecting because they control nomination decisions and the vast majority of director elections are uncontested, with only the board's slate presented for election by shareholders. Board self-determination makes sense, because the board is best positioned to understand the expertise and skill sets that are needed to manage the business and affairs of the company. Boards nevertheless struggle with decisions to end a director's service. The annual re-nomination of directors appears to be the assumed outcome at many boards, rather than the product of active and informed deliberation about the needs of the company and the qualifications and performance of the directors.

While shareholders maintain the ability to vote against the board-nominated slate and put up a competing slate, these mechanisms require concerted campaigns if they are to succeed and therefore are not often undertaken. As a result, institutional investors are interested in, and are increasingly seeking to influence, how board composition and strategic direction are aligned, the diversity among board members, and the mechanisms the board has adopted to prevent undue entrenchment.

Against this background, this article explores:

- The relationship between board turnover and changes in the company's strategic needs and in the business environment.
- Recent data on board diversity.
- The importance of board refreshment mechanisms, including limits on board service.
- The ways in which increased investor focus on board composition issues is affecting board composition decisions and related processes and disclosures.

BOARD TURNOVER

The rapid pace of change in the business environment and increasing expectations imposed on public company boards underscore the need for corporate governance and nominating committees to continually assess whether the composition of the board is appropriate for the evolving complexity of the business. Board composition should relate to the company's strategic needs, which change as a company and its business environment evolve. Corporate governance and nominating committee efforts need to focus on nominating and retaining those directors who together reflect the mix of skills, experiences, backgrounds, and independence that will best position the board for effective decision-making relating to the business.

Boards also need to balance interests in continuity with the need for fresh perspectives and diversity that board refreshment can bring. Recent data suggests that corporate governance and nominating committees may be overweighting the value of continuity on the board, leading to concerns about board entrenchment and independence. According to a study by Spencer Stuart, director turnover remains low, at just 0.81 director positions turning over per year at S&P 500 companies, although higher than the turnover rate of 0.72 in 2016 (Spencer Stuart, *The 2017 Spencer Stuart U.S. Board Index* (Spencer Stuart Study), available at *spencerstuart.com*). While this demonstrates improvement, the number of new independent directors in 2017 at S&P 500 companies remains below the levels seen 15 years ago (from 401 new directors in the S&P 500 in 2002 to 397 new directors in 2017). This stagnation is particularly notable given the increased attention and pressures from institutional investors.

The reduction in turnover of public company boards is associated with increasing director age and heavy reliance on formal age limits as the primary board refreshment mechanism. The average age of an independent director serving on an S&P 500 board is 63.1 years (two years older than the average age in 2007). Almost 20% of directors are 70 years old or older and 5% are 80 years old or older. Not surprisingly, age limits are rising as well. For example:

- A majority of S&P 500 boards set the age limit at 73 years old or older, with 42% at 75 years old or older (compared with just 11% at 75 years old or older in 2007).
- Four S&P 500 boards set the age limit at 80 years old.

Directors have postponed retiring due to health and longevity improvements generally, and due to the economic downturn that impacted retirement savings.

The average tenure for independent directors on S&P 500 company boards is 8.2 years. However, notwithstanding increased scrutiny by investors regarding long-serving directors, only 5% of S&P 500 boards set tenure limits, up from 4% in 2016.

BOARD DIVERSITY

Slow director turnover has the potential to reduce the ability of boards to change composition to meet evolving needs. It also reduces the diversity of experience and viewpoints in the boardroom by impeding increased representation of women and racial minorities.

Boards of S&P 500 companies continue to be relatively homogenous and statistics show that board diversity is growing at a glacial pace. The percentage of women directors is growing at just over one-half of a percentage point per year, and racial diversity is growing at an even slower rate. For example:

- Only 22% of S&P 500 directors are women, up from 16% in 2007.
- 17% of the top 200 S&P 500 board seats are filled by racially diverse directors.

(See Spencer Stuart Study.)

The proportion of women and racially diverse directors is even lower at Russell 3000 companies. According to Institutional Shareholder Services Inc. (ISS), as of June 30, 2018, 16% of Russell 3000 companies in the US had no female directors, compared to 21% at the end of 2017. (ISS, *United States Governance Principles Survey* (July 30, 2018), available at *issgovernance.com*.)

US boards lag behind European boards, where diversification has been made a priority through government regulation and pressure, including the imposition of quotas. While quotas appear to increase the number of women on boards in other jurisdictions, they remain controversial as a solution to board diversity in the US because:

- Quotas limit board discretion to determine appropriate board nominees based on the company's needs.
- Women placed on boards to satisfy quotas may be viewed as less deserving of the position.
- Quotas may in practice become the outer limit on gender diversity for some boards, functioning as both the floor and the ceiling.

The California legislature recently moved to adopt gender quotas for certain companies incorporated or having their principal place of business in California (see *Box, California's Gender Quota for Public Company Boards*).

BOARD REFRESHMENT MECHANISMS

Re-nomination decisions present challenges due to the natural reticence to disturb the status quo of the board absent a significant issue of director underperformance. Yet the business environment and company needs are continually changing. Boards must thoroughly analyze their compositional needs and regularly evaluate individual directors to inform re-nomination decisions.

Unfortunately, most corporate governance and nominating committees are not rigorously assessing directors or conducting regular "clean-sheet" assessments of the board's needs in terms of skill sets and experience, as recommended by the National Association of Corporate Directors (NACD) (see NACD, *Report of the NACD Blue Ribbon Commission on Building the Strategic-Asset Board* (2016), available at *nacdonline.org* (subscription required)). Notwithstanding the fact that most directors stand for election and must be re-nominated on an annual basis, the unspoken assumption is that directors will continue to serve until they no longer wish to or until they reach an age or term limit imposed by the board (and age and term limits are often subject to modification or waiver). The overall result is fewer director searches and fewer opportunities for new perspectives and experiences to be represented on the board.

Boards should be sensitive to board composition needs and diversity concerns, and should consider whether board culture and processes sufficiently allow for change. Along with considering the company's strategic direction, boards should annually assess individual director capacity and contributions when evaluating board composition.

LIMITS ON BOARD SERVICE

Where boards find it difficult to rigorously consider board re-nomination decisions due to board culture, boards should explore adopting limits on board service. However, both age and term limits pose concerns because they allow some directors to serve longer than they should by setting an expected length of service at the outer limits, but fail to prevent other directors from leaving the board when they may still have plenty to contribute.

Because of the potential forced exit of highly effective directors, many boards make exceptions to age and term limits, and those exceptions then become the rule. Age and term limits often reflect an expectation that a director's tenure will last until the limit, and these limits have been rising (see above *Board Turnover*).

Regular, rigorous individual director evaluations in connection with re-nomination decisions reduce the arbitrariness of term and age limits. However, boards are wary of implementing rigorous director evaluations for use in re-nomination decisions because the practice of regularly determining to "vote someone off the island" is viewed as antithetical to the culture of trust among directors that is core to effective board functioning.

Boards that prefer implementing age or term limits could consider:

- **Adopting an "independence term limit."** Under this tactic, after nine to 12 years of service, a director would no longer qualify as independent. A truly valuable director could remain on the board, but his or her continued service would impact the board's independence ratio and may require committee composition changes. This would cause the board not to extend the director's service without a very good reason. (The independence term limit is an adaptation of the UK rule that independent directors are limited to nine years in that role.)
- **Implementing an in-depth review.** Under this tactic, the board could implement an in-depth review of a director's performance, and his or her expertise and skill sets in relation to the board's oversight needs, when the director reaches a set age or level of service on the board.

Search Corporate Governance Practices: Commentary for more on limits on board service.

SHAREHOLDER ACTION AND ENGAGEMENT

Unless corporate governance and nominating committees address the issue of board refreshment and succession planning in a more rigorous manner, boards may start to see greater activity from shareholders who believe that increased board turnover and diversity is beneficial. Shareholders may use tools that have proven powerful in addressing other issues to force board turnover, including:

- Campaigns to vote against members of corporate governance and nominating committees at companies that have very little board turnover or do not have gender and racial diversity on the board.
- Shareholder proposals seeking enhanced board turnover mechanisms or dismantling takeover defenses that may impede board composition change.
- Proxy access proposals targeting boards that shareholders view as intractable, on the theory that shareholders need an ability to nominate directors where the board appears entrenched or lacks diversity.

Search How to Handle Shareholder Proposals for more on the steps a company should take after it receives a shareholder proposal.

California's Gender Quota for Public Company Boards

On August 30, 2018, the California State Senate approved a bill (SB 826) to require corporations with shares listed on "a major United States stock exchange" and incorporated or headquartered (as disclosed on the corporation's annual report on Form 10-K) in California to include a certain number of female directors on the board, with the number determined by board size. The bill would require that by the end of:

- 2019, such companies have a minimum of one female director on the board.
- 2021, such companies have a minimum number of:
  - two female directors if the corporation has five directors; and
  - three female directors if the corporation has six or more directors.

Failure to comply with this mandate could result in civil penalties, ranging between $100,000 and $300,000. The bill would also require that the California Secretary of State publish various reports on its website documenting, among other things, the number of corporations in compliance with these provisions. The bill would also authorize the Secretary of State to impose fines for violations. As of press time, Governor Jerry Brown has not signed the bill and it is unclear whether he plans to do so.

While the policy objective of encouraging greater representation of women on corporate boards is laudable, reliance on a strict gender-based quota may render SB 826 vulnerable to constitutional attack under the federal Equal Protection Clause, unless California can show that SB 826 "serves important governmental objectives" and "the discriminatory means employed are substantially related to the achievement of those objectives" (*Miss. Univ. for Women v. Hogan*, 458 U.S. 718, 724 (1982)). SB 826 may also be vulnerable to challenge under California's Equal Protection Clause.

Public companies should inform their corporate governance and nominating committees about these campaigns and consider how to respond to questions from their investors about board composition, diversity, and refreshment. Those with fewer than two female directors should pay particular attention to the guidelines and policies of their institutional investors so they can explain conformity with (or deviation from) expectations about board diversity.

Boards and their advisors should consider how to engage with shareholders on board composition, diversity, and refreshment. This requires being able to articulate the board's position on:

- **Refreshment mechanisms.** Boards should consider whether the board has adopted sufficient mechanisms to prevent undue board entrenchment, including review of:
  - age and term limits; and
  - individual director evaluation and re-nomination decisions.
- **Diversity statistics.** Boards should discuss how their own diversity compares to emerging standards from:
  - key institutional investors;
  - proxy advisor policies; and
  - legislative and regulatory developments.
- **Diversity processes.** Boards should consider whether to adopt a policy that mandates that gender and racial diversity be reflected in any group of candidates being considered for a board position. For example, some companies require the board to interview at least one woman or minority candidate for each board vacancy (similar to the National Football League's "Rooney Rule" for filling head coaching and senior operations positions).
- **Disclosure and communication.** Boards should consider whether there are opportunities to improve disclosure and communication regarding:
  - alignment of the company's strategic direction and other unique aspects of its oversight needs with director skill sets and areas of expertise;
  - board diversity in terms of gender, race, age, geography, and skill sets (for example, in matrix format) and the value that the board and the company place on diversity;
  - the approach to board succession planning; and
  - board, committee, or individual director self-evaluation processes.

INVESTOR FOCUS ON BOARD COMPOSITION

Key institutional investors, as well as proxy advisors and hedge fund activists, are scrutinizing board composition and refreshment, with a particular focus on the alignment of director skill sets with corporate strategy and the level of gender diversity on boards. Notable activities are discussed below.

BLACKROCK

In February 2018, BlackRock issued updated proxy voting guidelines underscoring its expectation that US public companies in its portfolio will have at least two female directors. BlackRock may vote against corporate governance and nominating committee members "[t]o the extent that

[BlackRock believes] that a company has not adequately accounted for diversity in its board composition." (BlackRock, *Proxy Voting Guidelines for U.S. Securities* (Feb 2018), available at *blackrock.com*.) BlackRock concurrently sent letters to Russell 1000 companies with fewer than two female directors (approximately 300 companies) urging them to report on their efforts to increase board diversity.

In March 2018, BlackRock published a note outlining its views on board diversity and its approach to engagement on the topic (BlackRock, *BlackRock Investment Stewardship's Approach to Engagement on Board Diversity* (Mar. 2018), available at *blackrock.com*). The note lists nine topics that BlackRock may cover when inquiring about board composition and the process for evaluating and appointing directors. Additionally, in its Investment Stewardship Report for the second quarter of 2018, BlackRock reported that it had many productive engagements in which it "explored the companies' views on diversity, approach to board composition, performance evaluation and director succession and commitment to enhancing governance practices" (BlackRock, *Investment Stewardship Report: Americas, Q2 2018* (June 30, 2018), available at *blackrock.com*).

CalPERS

In March 2018, CalPERS identified board diversity as a "high priority initiative" and announced plans to vote against or withhold votes from directors at targeted companies that failed to take steps to add female directors. This follows its efforts in 2017 to engage with more than 500 companies regarding the lack of female directors on their boards.

NEW YORK STATE COMMON RETIREMENT FUND

The New York State Common Retirement Fund announced in March 2018 that it will vote against all directors at companies with no female directors on the board and against corporate governance and nominating committee members at companies with only one female director.

NEW YORK CITY PENSION FUNDS

In September 2017, New York City Comptroller Scott M. Stringer and the New York City Pension Funds announced the "Boardroom Accountability Project 2.0," focusing on board composition to position boards "to deliver better long-term returns for investors." (The same group launched the highly influential first phase of the "Boardroom Accountability Project" in 2014, to spur large public companies to adopt proxy access.)

In connection with the Boardroom Accountability Project 2.0, the NYC Comptroller sent form letters to the boards of 151 companies (80% of which were in the S&P 500 and 92% of which had adopted proxy access) seeking information about each board's composition and its processes for board refreshment and evaluation. The letter called on companies to annually disclose a "board matrix" (a sample of which was provided) that would indicate each director's skills and experience, as well as age, tenure, gender, race/ethnicity, and sexual orientation (if voluntarily disclosed). The letter also sought engagement with one or more directors about the company's processes for refreshing the board and highlighted potential topics for discussion.

In June 2018, the NYC Comptroller provided the following updates on the status of the campaign:

- Approximately 80% of the 151 targeted companies responded to the letters.
- Since September 2017, the NYC Comptroller's office engaged with management teams and directors at more than 85 of the targeted companies.
- More than 35 targeted companies now disclose details about the gender and racial and ethnic diversity of directors.
- Since September 2017, 49 targeted companies have elected 59 new directors who identify as women or people of color, and 24 companies have publicly committed to include women and people of color in the candidate pool for every future board search.
- More than 25 targeted companies provided enhanced disclosure about their annual board evaluation processes.

In August 2018, the NYC Comptroller and the New York City Pension Funds published a report highlighting what they consider to be the most transparent disclosures about board composition and diversity from the 2018 proxy statements of companies targeted in the Boardroom Accountability Project 2.0 (New York City Comptroller Scott M. Stringer and New York City Pension Funds, *"Best Practices" in Board Matrices* (Aug. 2018), available at *comptroller.nyc.gov*).

STATE STREET

In 2017, State Street issued guidance on enhancing gender diversity on boards and voted against or withheld votes from corporate governance and nominating committee chairs at approximately 400 of its portfolio companies in the US with no female directors. According to State Street, approximately 150 of the targeted companies had added at least one female director as of March 2018, and State Street is continuing to press the remaining companies to add female directors.

VANGUARD

In its 2017 annual letter from Chairman and CEO William McNabb to portfolio companies and in the accompanying press release, Vanguard indicated that it views board gender diversity as an "economic imperative." The letter highlighted Vanguard's long-term investment approach and outlined four governance-related pillars that guide Vanguard's proxy voting and engagement activity. (See Letter from F. William McNabb III, Chairman and CEO, Vanguard, to Directors of Public Companies Worldwide (Aug. 31, 2017), available at *vanguard.com*.)

Vanguard emphasized that it will continue to prioritize gender diversity on boards, noting that boards should be prepared to discuss their plans to make "meaningful progress over time" toward greater diversity. It also expressed interest in engaging with boards on a regular basis on these issues, rather than only in response to ballot items, and emphasized that such engagement should include opportunities for Vanguard to engage more with independent directors who have insight into board succession and other important governance topics.

Vanguard's 2018 Investment Stewardship Annual Report reveals that in 2018 Vanguard discussed board composition in more than 50% of its engagements and voted in favor of four out of nine shareholder proposals relating to gender diversity (Vanguard, *2018 Investment Stewardship Annual Report*, available at *vanguard.com*).

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PROXY ADVISORS

Beginning in 2019, Glass Lewis will generally recommend voting against corporate governance and nominating committee chairs at companies with no female board members, with limited exceptions.

ISS votes for director nominees based on four fundamental principles:

- Independence.
- Composition.
- Responsiveness.
- Accountability.

In its 2018 US Proxy Voting Guidelines, ISS added an express statement on diversity to the composition principle that boards "should be sufficiently diverse to ensure consideration of a wide range of perspectives" (ISS, *United States Proxy Voting Guidelines: Benchmark Policy Recommendations* (Jan. 4, 2018), available at *issgovernance.com*).

Additionally, although ISS stated that it would not make an adverse vote recommendation due to a lack of gender diversity in 2018, it highlighted in proxy research reports the boards that lacked gender diversity. For QualityScore purposes, ISS considers the number and proportion of women on a board and will give maximum credit when three or more women serve on the board or when at least 50% of board seats are held by women.

ISS also addressed board gender diversity in its Governance Principles Survey, the results of which it will consider when updating its proxy voting policies for the 2019 proxy season. Specifically, ISS sought updated input on the level of concern when there are no female directors on a public company's board and what actions should be taken in response. ISS asked the same question in its 2017 survey and 69% of respondents said the lack of any female directors is problematic (see ISS, *2017-2018 ISS Global Policy Survey: Summary of Results* (Sept. 25, 2017), available at *issgovernance.com*).

Search Developing Relationships with Proxy Advisory Firms for more on the role of proxy advisors and tactics for effective proxy advisor engagement.

HEDGE FUND ACTIVISTS

Many, if not most, campaigns by hedge fund activists seek to change the composition of the board. Because they are seeking opportunities to extract value from companies they have identified as undervalued, activists often assert that the board needs to add industry or other experts to refresh the board. Candidates nominated by activists often have a relationship with the hedge fund as a principal or an employee of the hedge fund to ensure the activist's influence at the board level to push the company to take action that will return financial value to the hedge fund in the relatively near term.

In 2017, ISS and the Investor Responsibility Research Center Institute (IRRCi) published a study on the impact of activism on board refreshment at S&P 1500 companies targeted by activists. The study found that activist nominees and directors appointed to boards by activists through settlements were nearly three times more likely to be "financial services professionals" compared to directors selected through a board's regular nomination process. (See ISS and IRRCi, *The Impact of Shareholder Activism on Board Refreshment Trends at S&P 1500 Firms* (Sept. 7, 2017), available at *irrcinstitute.org*.)

Notably, activist slates tend to put forward fewer diverse candidates than other board slates. According to the ISS and IRRCi study, women comprised only 8.4% of dissident nominees on proxy contest ballots and directors appointed through settlements with activists, and only 4.2% of dissident candidates and directors were ethnically or racially diverse.

Activists often will take issue with long-serving directors, taking the view that such directors are entrenched and cannot provide objective oversight.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.