THE MISSING LINK

By Cherie Sorokin & Kris Veaco

- **State Street Global Advisors ("SSgA") has issued its director tenure policy containing a formula for director tenure reflecting their concern that long-tenured directors on boards may reflect "a lack of refreshment of skills and perspectives on the board. It may also limit a board's ability to bring on new directors without increasing the board's size. In addition SSgA believes that long tenure may also diminish director independence."**

- **The Council of Institutional Investors ("CII") sees the board evaluation process as a potential catalyst for board refreshment and has called on companies to include some disclosure of the board evaluation process in their proxy statements.**

- **ISS now includes director tenure in its Quickscore.**

Investors are increasingly paying more attention to board composition, director tenure, and board effectiveness reviews as important factors in their analysis of companies' overall governance.

In particular, as is evident in the bullet points on the left, individual director performance seems headed for additional scrutiny. Director tenure is already a major area of investor interest, but as investors also begin to look for increased disclosure of board evaluation processes, calls for processes to evaluate individual director performance are bound to increase.

We believe each board is in the best position to determine whether its members are contributing to the overall effectiveness of the board, but to do so requires a sound, thoughtful process. Developing such a process can be time-consuming, particular if a company has not yet developed robust criteria for board service, a director skills assessment process, or a board succession planning process. Additionally, similar to an overall board evaluation, questions to be used as part of the individual director assessment process need to be tailored to the individual company. But taking the time to create a well-thought-out process for individual director assessment and disclosing that such a process exists will go a long way to satisfy investors that the board itself has the matter of its own composition in hand. It should also help counter tendencies to rely on age or term limits as board refreshment mechanisms as these mechanisms, in our opinion, are overly arbitrary and don't address skills issues or organizational needs. An additional benefit of a process that allows for the regular review of both board and board member effectiveness is that it creates a culture that recognizes the value of bringing additional skills and competencies to the board and removing unproductive board members so they do not impair the overall effectiveness of the whole board. It also may introduce the notion of expected change on the board to a board culture where the expectation has typically been that once you join a board, you often stay for as long as you want to.

Formal board evaluation processes first became prevalent in the 1990s. While articles have been written and conversations have been had on the efficacy of including director self-assessments and peer reviews as part of board evaluations since the early days, such reviews of individual director performance have not been common. In our opinion, the lack of emphasis on individual director evaluations has been a major "missing link" in board evaluation processes as they have developed in recent years. Resistance to examining individual director effectiveness is often couched in terms of fears that such reviews have the potential to destroy board collegiality. Because a majority of board evaluations are still handled internally by the corporate secretary or a board member, additional concerns have been expressed as to whether board members could or would be candid under these circumstances. Regardless of the rationale, peer reviews where directors are asked to comment either in writing or orally on the performance of fellow directors have continued to be largely avoided and director self-assessments, where directors are given the opportunity to reflect on their own effectiveness are still not common.

In PwC's 2014 Annual Corporate Directors Survey a growing number of the directors surveyed believe there is a need for some board refreshment, and an even larger number acknowledge there are impediments to replacing underperforming directors. They cite board leadership being uncomfortable addressing the issue and the lack of individual director assessments as the main reasons for not addressing the issue of underperforming directors. While many directors felt their board evaluation was effective, almost two-thirds of the directors surveyed felt their board assessment process was a "check-the-box" exercise.

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These results reflect what we as governance consultants have found as we work with companies on board evaluations: in-house assessment processes can easily become rote and they are often not as effective or as helpful as they could be, especially when boards fail to consider individual director effectiveness as part of the overall evaluation process. When we conduct board evaluations as outside governance consultants, we recommend that the process include director self-assessments and peer reviews. We find that directors are willing to actively participate in this aspect of the board evaluation precisely because we are outsiders – trusted outsiders. It is easier for board members to be candid with us and, conversely, we are able to be more candid with them. When directors are given the opportunity to reflect on their own performance, we have found that they are willing to identify and address areas where they might need to be more effective. They just haven't been asked to do so before.

When we deliver the results of peer reviews to individual directors, we have found that changes in director behavior often occur and, in some cases ultimately lead to changes in board composition. Results can also be reported to the board's governance committee and leadership in ways which can help them understand and take steps to address director concerns about individual director performance. In effect, the process can help the board culture evolve to one where appropriate action is natural and expected when problems are surfaced. There is clearly a link between having effective individual directors and having an effective board overall. In our opinion, it's well past time to officially acknowledge that link and to begin to incorporate individual director evaluations into board evaluations on a regular basis.

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