KPMG

Audit Committee Institute

On the 2019 Nomination Committee agenda

For many years the nomination committee has been considered the poor relation of the traditional main board committees – not receiving the regulatory attention of the audit committee nor attracting the media profile of the remuneration committee. However, nomination committees are now in the firing line with investors, the media, activists, proxy advisors and others looking to hold the committee to account for a wide range of issues including board skills and diversity, performance, succession planning (executive and non-executive), independence, tenure, over-boarding and disclosure.

Drawing on insights from our conversations with board chairs, nomination committee members and company secretaries over the past twelve months, we have highlighted ten issues that, in our opinion, nomination committees should keep in mind as they approach and execute their 2019 agendas.

1. Looking ahead

The number one item on the nomination committee agenda is the alignment of boardroom talent with the corporate strategy, both for the short and long-term. Whether it's addressing a gap around technology or finding people who have international experience, talent needs to be part of the strategy discussion.

Boardroom composition and succession should start with clarity over the company strategy and a clear view of the needs of the business over a range of time horizons, closely followed by an examination of the skills gaps in relation to those needs. Before developing plans for long-term succession, use skills matrices to identify current and future skills gaps and think about the time requirements, the role of ongoing professional development and the output from the annual board evaluation and individual performance exercise. Think about both 'business as usual' and emergency scenarios.

Nomination committees also need to look ahead in order to understand when individuals are due to (or likely to) leave the board. Scenarios where a number of directors are planning to leave at the same time, or are required to rotate off the board, need handling carefully both in terms of disruption and corporate memory, but also in terms of managing investor expectations.

Finally, when considering CEO succession, be wary of looking to clone the current CEO. Their characteristics should have been fitting at the time of their appointment but may no longer be appropriate when the successor is due to take over. Ensure a comprehensive review is undertaken by the committee of the role description and skills requirements.

2. Plan for increasingly active investors

In an environment where FTSE350 company directors face annual election, institutional investors are increasingly using targeted voting practices to register their displeasure at particular governance practices – whether that be voting against there-election of the remuneration committee chair to register a perceived unwillingness to change executive pay arrangements or against the audit committee chair in the light of accounting irregularities, or a failure to adhere to perceived best practice.

In particular, expect proxy agencies to recommend voting against the nomination committee chair where: the roles of the chief executive and chair have not been split; where a senior independent director has not been appointed; where the board has not conducted an externally facilitated evaluation of its effectiveness within the past three years; or where an individual who has a significant conflict of interest, or whose past actions demonstrated a lack of integrity or inability to represent shareholder interests is nominated (or re-nominated) to the board.

Resolution type	Resolutions with 20%+ votes against 2018	2017
Audit and reporting	1	4
Director elections	56	25
Issue of shares & pre-emption rights	23	26
Remuneration - policy	22	28
Remuneration report	32	30
Shareholder rights	8	5
Political activity	2	2
Totals	**144**	**120**

Source: Investment Association's Public Register
(FTSE 350 data 1 November 2017 to 31 Auguest 2018)

Large institutional investors are also using their voting powers to reduce the number of over-boarded directors on boards. Three FTSE100 directors received less than 80% support for their re-election during the 2018 AGM season due to being on too many boards and a further eight FTSE 250 directors had a similar experience.

Be aware that an increasing number of institutional shareholders are adopting specific policies on the number of boards that directors sit on and the 2018 UK Corporate Governance Code – effective for accounting periods commencing on or after 1 January 2019 - makes specific reference to the time commitment of directors and states that companies should take into account other demands on directors' time when making new appointments.

Going forward, be cognisant of the new provision in the 2018 UK Corporate Governance Code which effectively limits the tenure of the board chair to nine years of board service. Though the provision does offer some flexibility to facilitate effective succession planning and the development of diverse boards, we anticipate that this will be an area of investor focus in future years.

We estimate that around 20% of FTSE350 Chairs would currently fail this new test, and while the 'comply or explain' regime could be used to rationalise non-compliance with the Code, the existence of a compliance culture may well drive board leadership churn and, with a cap of nine years of board service, nomination committees might be more inclined to look outside the existing board rather than make an internal 'promotion'.

3. Challenge conventional wisdom

Rapid technological change and new disruptive business models challenge the more traditional approaches of many established businesses.

Companies need to consider the impact on their board and to look at a wider pool of candidates in order to identify people with the skills needed for them to meet the challenges they face in this new environment.

Is the 20th century paradigm of filling boards with directors with 'big company' experience still relevant in an age where an understanding of 'new' technology and the agility to manage the consequential opportunities and risks are vital to success? Are today's boards lacking executive currency, youth and/or IT literacy? Individuals with deep technological expertise can be hired at an executive level, but boards still need to be able to 'ask the right questions' and just as important, 'understand the answers'.

It is always desirable to find individuals with specific skills who are also capable of contributing across the range of issues the board faces – not least because the board as a whole is responsible for all decisions, regardless of the expertise or knowledge of an individual director in that area – but have the risks around inexperience been overstated? Is there a role on (or as an advisor to) the board for the "bright young things"of the technology world - if not for the usual three terms of three years, then perhaps for a shorter term?

Consider looking beyond the 'usual suspects' to find people with different experiences and backgrounds – including those who have not served on a listed company board before. With appropriate induction, mentoring and coaching, new directors should be able to adapt reasonably quickly.

Alternatively, consider the use of an advisory body – composed of independent individuals with expertise in specific fields - to advise the board on areas such as technology and innovation. Being less onerous in terms of time commitment and legal responsibilities, such roles might be more attractive to younger less experienced individuals.

4. A diverse board is a better board

Does the board have the right combination of skills, backgrounds, experiences, and perspectives to probe management's strategic assumptions and help the company navigate an increasingly volatile and fast-paced global environment?

Diversity is not just about race, gender, sexual orientation and disability, important though they are. It's also about the richness of the board as a whole and the combined contribution of a group of people with different skills and perspectives.

People with different experiences, backgrounds and life-styles who together are more able to consider issues in a rounded, holistic way and offer an attention to detail that might not be present on less diverse boards.

Geographical or international diversity is also important for businesses operating across many different markets. Consider using psychometric profiling to assess the emotional intelligence of existing and incoming board members.

Styles of thinking

Polarisation of thinking styles amongst UK audit committee members, and by extension non-executive directors in general

81%	Cautious with risk v Adventurous with risk	**19%**
83%	Focus on the bigger picture v Focus on detail	**17%**
11%	Ruled by the heart v Ruled by the head	**89%**
10%	Autonomous v Collaborative	**90%**

Source: ACI survey of 165 audit committee members, 2015

A chairman that understands the differences between board members and how they approach any given situation will be better placed to harness their skills and attributes and ensure that the board as a whole is greater than the sum of its parts.

Think about the breadth of the talent pool from which new board members are sought. Has sufficient attention has been given to recruiting directors with backgrounds in the third sector, academia and government, as well as entrepreneurs and those from family businesses?

Challenge recruitment firms to provide a more diverse list of candidates and be specific about the skills and attributes required. Nomination committees that are themselves diverse, are likely to be more open to bringing in others from more diverse backgrounds.

5. Consider the depth of the committee's remit

Do the nomination committee terms of reference reflect the actual role carried out by the committee? Is the committee's role restricted to leading the process for board appointments or does it extend as far as executive and senior employee succession and talent management?

Note that compliance with the 2018 UK Corporate Governance Code specifically requires that the nomination committee ensures plans are in place for the orderly succession to both board and senior management positions. How does the committee ensure there is adequate 'bench strength' within executive management as well as the traditional role of ensuring potential future board members are being identified and developed?

Care should be taken to ensure the line between oversight and management isn't breached as CEOs will, quite naturally, expect to take responsibility for appointing their own teams.

Also think about the role the committee plays with regard to the annual board evaluation, induction training and continuous development? Does the committee have a wider remit for other governance matters?

6. Examine the executive pipeline

Developing executives so that they are 'board ready' is a challenge for all companies. Does the nomination committee have adequate visibility over the executive pipeline? Are there internal candidates for board positions, how can board members help with their development needs (e.g., through mentoring) and how will the board carefully manage any unsuccessful internal board candidates?

One way of assessing the top talent within a company is for nomination committee members (and other non-executive directors) to have one-on-one conversations with the key players in the business to gain a better understanding of the culture, strategy, key risks, areas of concern etc., and to get to know the leaders outside of the formality of the boardroom. Sit down with the key people in their 'natural habitat,' without an agenda. Just visit them in their office and have a conversation about things that are on their radar ... or yours.

Board-level skills can be developed through executives taking on roles on subsidiary boards or as non-executive directors elsewhere. This can benefit both the companies involved and the individual, however the challenges of performing a board role whilst maintaining an executive career should not be underestimated – particularly where the companies concerned have concurrent year-ends.

7. Take account of wider stakeholder perspectives

When recruiting any director, the nomination committee should take the stakeholder perspective into account when deciding on the recruitment process and the selection criteria. Given the significant influence that a company's key stakeholders have on its future prospects and its licence to operate, the board's knowledge and understanding of the interests of those stakeholders should be among the factors that are considered when assessing the overall composition and balance of the board.

It will be for the board to decide how much weight should be given to these factors.

Note that the 2018 UK Corporate Governance Code sets out that in order to engage effectively with the workforce the board should employ one or a combination of (a) a director appointed from the workforce; (b) a formal workforce advisory panel; or (c) a designated non-executive director.

Each of the three suggested methods for engaging with the workforce have their merits and challenges and our publications Workforce directors, Designated non-executive directors and Workforce advisory panels explore some of these.

When a company considers that one or more individuals should be appointed specifically in order to bring the perspective of a particular group to the board's discussions, there may be benefits in having other directors with experience of the same or other stakeholders. This can reduce the risk of the board becoming over-reliant on individual directors, or of other groups of stakeholders being inadvertently overlooked.

8. The board as a catalyst for culture

When considering the composition of the board (and senior management team) nomination committees need to be cognizant of the key role played by such individuals in both determining and sustaining the desired corporate culture. Does the nomination committee explicitly consider culture and values when developing its succession plans and whether potential candidates exhibit the desired culture? How does the nomination committee develop an understanding of a candidate's cultural fit and the impact they have had in other organisations?

Similarly, if the company needs to change its culture, how might succession planning assist and take into account the journey required to achieve the desired culture? How does the committee develop an understanding of whether executive management are living the desired culture and how does that align with progress and promotion?

9. Be transparent

Investors are increasingly interested in succession planning arrangements and how boards assess both director and management performance, yet it can be argued that many nomination committee reports lack the rigour and attention to detail associated with both audit committee and remuneration committee reports.

Indeed, the Financial Reporting Council's (FRC's) Feedback Statement on their UK Board Succession planning discussion paper notes that notwithstanding boards' natural caution about the potential commercial and personal sensitivity when reporting on succession plans, investors felt that the quality of reporting could be greatly improved.

Note that compliance with the 2018 UK Corporate Governance Code specifically requires a description of the work of the nomination committee, including the process used in relation to appointments, its approach to succession planning and how both support developing a diverse pipeline. Furthermore, the policy on diversity and inclusion should be disclosed, including its objectives and linkage to company strategy, how it has been implemented and progress on achieving the objectives. The inclusion of targets and metrics are useful.

In addition, the FRC Feedback Statement notes that investors felt that current disclosure about board evaluation is insufficient. The 2018 UK Corporate Governance Code seeks to address this by 'requiring' disclosure of how the board evaluation has been conducted, the nature and extent of an external evaluator's contact with the board and individual directors, the outcomes and actions taken, and how it has or will influence board composition.

10. Committee composition

The composition of a nomination committee will depend on the particular circumstances of the company and its future strategy. Experience of HR, talent management and recruitment are beneficial, but the number of specialists available will naturally be constrained by the size of the company (and the board itself). Where necessary, knowledge and capability gaps can be filled (in part) by expertise from within the company (head of HR, head of talent) and/or external recruitment specialists (head-hunters). It is important to understand the CEO's views, particularly on internal talent. While smaller boards tend to have all their non-executive directors as members of the nomination committee, this is not always possible or even desirable for larger boards. In such circumstances, steps should be taken to ensure appropriate coordination and dialogue takes place between board committees, and in particular between the nomination committee and the remuneration committee – both of which need a grasp of performance and reward.

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