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Audit Committee Institute

On the 2020 Nomination Committee agenda

With the rise of activist investors it is the turn of nomination committees to come into 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, we highlight the issues that nomination committee should keep in mind as they approach and execute their 2020 agendas.

Aligning talent to the strategy

The item at the top of the nomination committee agenda continues to be pipeline management and how best to align 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 starts with clarity over the company strategy – identifying the business requirements and how they need to develop over time allows for a detailed examination of the skills required to deliver on them. Use skills matrices to identify current and future skills gaps and remember to factor the opportunities for ongoing professional development when developing long term succession plans.

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. The company may have changed since they were appointed and different characteristics may be more crucial to the future success. Ensure a comprehensive review is undertaken by the committee of the role description and skills requirements.

Incorporating wider stakeholder perspectives

Stakeholder perspectives are relevant for all board appointments and should be considered throughout the recruitment and selection process for every new director appointment. 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 is vital.

Cementing the value of workforce stakeholder opinion, the Code mandates their place in the board room. The Code requires 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, or explain why an alternative arrangement is considered by the board to be effective.

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.

While these workforce appointments will ensure new stakeholder perspectives are brought into the board room, care should be taken to ensure that they are not inadvertently treated as representative of all other stakeholder groups.

Similarly, the appointment of individuals with multiple stakeholder experiences can reduce the risk of the board becoming over-reliant on individual directors, or of other groups of stakeholders being inadvertently overlooked.

Planning 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 the board, voting against re-election of directors from the remuneration committee chair who displayed an unwillingness to change executive pay arrangements to the audit committee chair who presided over a period of accounting irregularities.

Large institutional investors have for some years been using their voting powers to reduce the number of over-boarded directors on boards, often through specific policy choices. This has been recently validated by the 2018 Corporate Governance Code (the Code) which makes specific reference to the time commitment of directors and requires companies to take into account other demands on directors' time when making new appointments.

Resolution type	Resolutions with >20% votes against 2019 YTD	2018
Director elections	31	39
Issue of shares & pre-emption rights	17	19
Remuneration – policy	4	9
Remuneration report	30	30
Other	15	19
Total	**97**	**116**

Source: Makinson Cowell

The nomination committee chair in particular should be wary of non-adherence to best practice, and can expect to be voted against if: the roles of the chief executive and chair have not been split; a senior independent director has not been appointed; the board has not conducted an externally facilitated evaluation of its effectiveness within the past three years; or 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.

Consistent with 2018, three FTSE100 directors received less than 80% support for their re-election during the 2019 AGM season due to overboarding and a further four (2018: eight) FTSE 250 directors had a similar experience. In addition there is an increasing tendency for the withdrawal of director re-election resolutions if significant shareholder dissent is encountered ahead of the AGM.

Developing the executive pipeline

Developing executives so that they are 'board ready' is a challenge for all companies, not least because the nomination committee typically struggle to get adequate visibility over the executive pipeline.

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 on-site and have a conversation about things that are on their radar ... or yours.

Once potential candidates for board positions have been identified current members should be challenged on how they can help with their development needs, such as mentoring. Board-level skills can be developed through 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.

The subject of diversity is also key to the pipeline – according to the recently released Hampton Alexander Review, "despite all of the learning and mound of empirical research on the business case, financial and operational benefits of diverse teams, the majority of appointments in leadership teams in the FTSE 350 are still going to men."

The risk of internal applicants being unsuccessful should not be underestimated – only valued employees are likely to make it into the candidate pool and a knock back at the late stages would need to be very carefully managed.

Pipeline management is likely to become increasingly relevant over the coming years – the Code effectively caps the board chair role at nine years and this, combined with the diversity agenda and increasing focus on compliance, is likely to drive board leadership churn. We estimate that around 47 FTSE350 Chairs, including 15 of the FTSE100, would currently fail this new test. So while the 'comply or explain' does offer some flexibility, nomination committees might be more inclined to look outside the existing board rather than make an internal 'promotion'.

Enriching through diversity

Core to the responsibilities of the nomination committee is ensuring that their board has the right combination of skills, backgrounds, experiences, and perspectives – to probe management's strategic assumptions; to enable management to navigate the company through an increasingly volatile and fast-paced global environment – and diversity is one of the most penetrative tools for achieving this.

Diversity is 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.

Diversity can be measured in so many ways: from race and gender, sexual orientation and disability, to geographical heritage. International diversity is especially important for businesses operating across many different markets.

A diverse board will, by definition, have a number of diverse personalities and getting the most out of them is what sets great chair persons apart: a chair who 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. Psychometric profiling can be a useful tool in assessing the emotional intelligence of existing and incoming board members.

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.

Challenging 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 of this on their board and 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.

Traditionally, boards sought out directors with 'big company' experience, but in this new age the ability to understand and leverage technology at speed are vital to success and so a different sort of experience is needed. Nomination committees who don't evolve risk creating boards which are found lacking in the most valuable executive currencies of youth and IT literacy.

Individuals with deep technological expertise can be hired at an executive level but board members still need to be able to 'ask the right questions' and just as important, 'understand the answers', in order to be capable of contributing across the range of issues the board faces – but have the risks around inexperience been historically overstated? And even if not, have they now been surpassed by the potentially higher risks associated with a board lacking in technology literacy?

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.

Refocussing on 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? Managing the balance can be difficult. While the nomination committee is required to ensure that plans for succession to both board and senior management positions are in place, it is management's responsibility to prepare and deliver on them.

The committee must ensure that there is adequate 'bench strength' within executive management while remaining cautious not to breach the line between oversight and management as CEOs will, quite naturally, expect to take responsibility for appointing their own teams.

As well as the traditional role of board appointments and pipeline, nomination committees may want to be considering their role with regard to the annual board evaluation, induction training and continuous development, as well as any wider remit for other governance matters.

Setting the tone from the top

When considering the composition of the board (and senior management team) nomination committees need to be cognisant 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?

Managing the 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 (headhunters).

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.

Increasing transparency for investors

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.

Compliance with the Code specifically requires a description of the process used in relation to appointments, the approach to succession planning, and how both support developing a diverse pipeline, as well as 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. Over and above these requirements, the inclusion of targets and metrics are useful to investors and therefore desirable.

The FRC Feedback Statement further notes that investors felt that current disclosure around 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.

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