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Focus on board composition

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Foreword

Board composition is in the spotlight. The business environment is fast-paced and complex, making it imperative that companies have the right people in the boardroom helping to guide strategy and oversee risk.

As we look ahead to 2018, we expect board composition and the related issues of director diversity, tenure, and qualifications to remain a high priority for companies, boards, investors, and other stakeholders. As evidence of the continuing importance of these issues, a number of high-profile institutional investors, including BlackRock, State Street, and Vanguard, focused on board gender diversity as an engagement priority in 2017.

Further ensuring that these issues will stay at the forefront in 2018, New York City comptroller Scott Stringer, the fiduciary for the five public pension funds within the New York City Retirement System totaling nearly $160 billion in assets, recently launched a campaign asking 151 companies to provide information about their diversity policies, including disclosure on the race and gender of their directors. Companies are also focused on these issues: An analysis by Equilar of 500 of the largest U.S. companies (by revenue) found that one in six included a board skills matrix in their 2017 proxy statements, up from about one in eight in 2016.

As a proud sponsor of Equilar's 2017 Board Composition and Director Recruiting Trends report, the KPMG Board Leadership Center (BLC), along with Semler Brossy Consulting Group, provided commentary on current trends in board composition and director recruiting. We encourage you to read the report and the associated commentary, which offer a comprehensive snapshot of what boards of public companies look like today, from board and individual director attributes and turnover to board and committee leadership.

To complement the insights gleaned from the Equilar report, the KPMG Board Leadership Center asked directors and thought leaders in corporate governance and board issues to share their views on how boards should approach the issue of refreshment, what companies should communicate to investors about the composition of their boards, the changes they expect to see in board composition, and what could help to move the needle on diversity in the boardroom. Their thoughts and insights appear in the pages that follow. We hope you will find their perspectives on the current state of board composition and what lies ahead helpful as you consider your own board composition and recruiting practices.

Interviewees

Patricia Salas Pineda

"Companies should proactively communicate to their investors how their board's skills, experiences, and diversity align overall with the business, its consumer base, and any plans to improve upon diversity."

Patricia Salas Pineda is a corporate and nonprofit board member and a former officer at Toyota Motor North America, Inc. and New United Motor Manufacturing, Inc. She currently serves as chair of the Latino Corporate Directors Association, as a board member of the Latino Donor Collaborative, and as an advisory board member of the Aspen Institute's Latinos and Society program. She also serves on the boards of Levi Strauss & Co. and Frontier Airlines.

Jared L. Landaw

"Nominating committees should approach board refreshment the same way that the general manager of a sports team seeking to build a championship-caliber franchise approaches recruiting."

Jared L. Landaw is a member of the board of directors of Costar Technologies, Inc. and Barington/Hilco Acquisition Corp. He is also the chief operating officer of Barington Capital Group, L.P., an activist investment firm that assists publicly traded companies in implementing initiatives to improve long-term value. Jared is a frequent speaker on activist investing, corporate governance, and board diversity and is a member of the Thirty Percent Coalition.

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Belen Gomez

"Investors are influencing, and will continue to play a major role in, how boards think about and approach board composition processes."

Belen Gomez is senior director of Research and Board Services at Equilar and oversees operations and partnerships related to Equilar's corporate governance research. She also leads Equilar's Diversity Network (EDN) initiative focused on increasing diverse representation in boardrooms across the globe. She has extensive experience working with boards and senior executives from Silicon Valley start-ups to Fortune 500 companies. Her research on board composition and executive compensation has been cited in several regional, national, and trade publications.

Blair Jones

"Boards need to continue to be vigilant in both increasing the number of women on boards and elevating them to leadership positions."

Blair Jones, managing director at Semler Brossy, has been an executive compensation consultant for over 25 years. She has worked extensively across industries in both the public and private sector and has particular depth of expertise working with companies in transitional stages. Most recently she has focused on the role of the board in fostering diversity throughout the organization.

Susan Angele

"I can envision a time when all board members are expected to have some level of technology literacy."

Susan Angele, senior advisor with the KPMG Board Leadership Center, engages with directors and business leaders of public and private companies on risk and strategy, talent and technology, globalization and compliance, financial reporting, and other board topics. A former Fortune 500 executive, Susan is a frequent writer and speaker on board diversity and board effectiveness, is a member of WomenCorporateDirectors, and a National Association of Corporate Directors Board Leadership Fellow.

In your view, how should boards approach the issue of board refreshment?

Patricia Pineda:
Aside from term or age limits, which many boards have adopted, the best ways to approach board refreshment are through regular, comprehensive board and peer assessments and ongoing reviews of the skills matrix and experiences needed to evolve the business. Board and peer assessments should indicate whether certain board members are underperforming and no longer meaningfully contributing to the board's discussion and work. In such cases, the board should respectfully request an underperforming director to step down. Regarding the board's skills and experiences, the board should ensure that the current directors' skills and experiences are relevant and in line with the skills and experiences required to advance the company's business strategies. This review may result in the board respectfully asking a board member whose skills are no longer as relevant to step aside to accommodate a new board member who can bring the critical missing skills or experience. The board should continuously be searching for a diverse talent pool in the event a need arises for a new board member.

Jared Landaw:
Nominating committees should approach board refreshment the same way that the general manager of a sports team seeking to build a championship-caliber franchise approaches recruiting. As opposed to filling vacancies on an "ad hoc" basis as and when board openings arise, nominating committees need to plan ahead in order to successfully assemble a board comprising the best available directors who address the company's needs. Doing so requires an in-depth understanding of what skills are required in the boardroom to meet the company's current and future strategic and operating requirements. It also requires an ongoing assessment of the board's strengths and weaknesses and whether its current members are meeting the company's needs. Finally, the board must have the gumption to replace directors who are no longer strong contributors or best suited to help create long-term value for shareholders.

Belen Gomez:
I'm not necessarily a fan of hard term limits to address mechanisms for board turnover. I believe and have observed some long-tenured directors delivering great value to the board and offering independent and steady leadership. However, I think there is greater opportunity for boards to be more proactive in evaluating director contributions. If it's a regular exercise for the board to have these assessments and discussions, it can serve as a catalyst for board refreshment. I imagine those conversations are never easy; it's never easy to ask a board member to step down, but with regular tools and processes in place, a board has the mechanisms available to take action when needed.

There is also an opportunity for boards to take a broader approach to looking for new directors. I understand the desire to look for someone who has served in the CEO role, but boards aren't going to find a diverse candidate pool that way—at least not yet. Broadening the scope and insisting on reviewing a diverse slate of potential candidates regularly is key for board succession planning and recruiting new directors.

Blair Jones:
Board refreshment needs to be approached from a business perspective and supported by strong board performance management and succession planning processes. These days, a board cannot assume that the skills that have served it well in the past will continue to be the appropriate skills for the future. Therefore, it's important that the succession planning process identifies the skills necessary to support the business priorities going forward and that the performance management process allows for candid conversations about the portfolio of skills the board needs and individual members' contributions.

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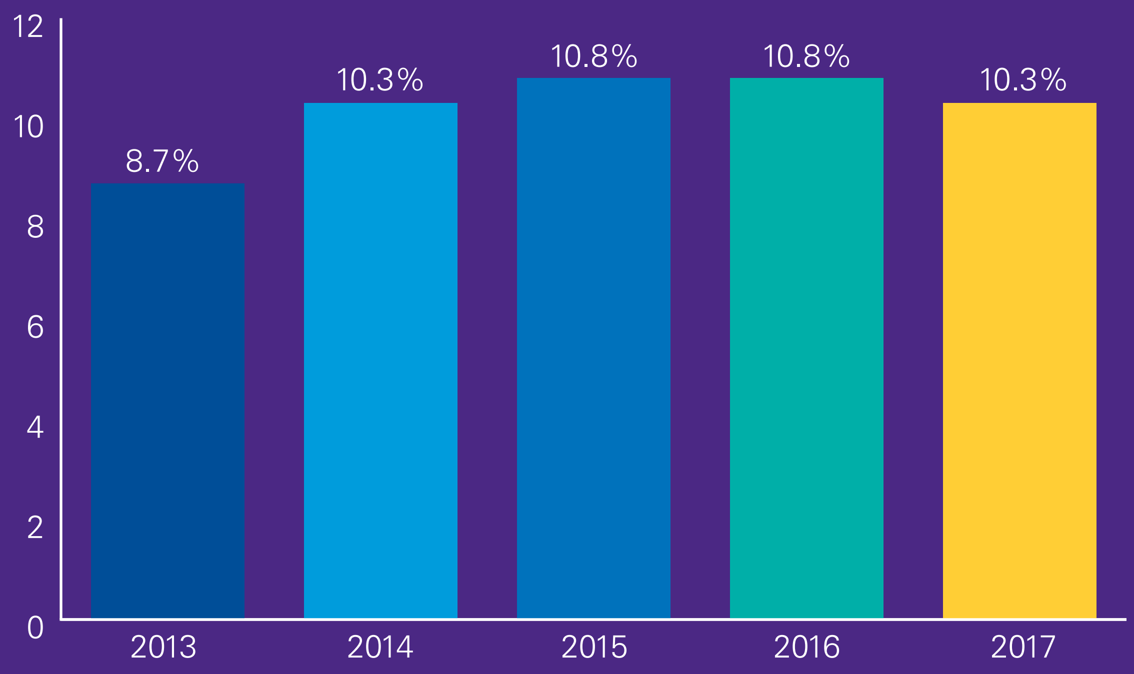
Susan Angele:
The talent needs of companies change as the business environment and company strategy change. This is as true or truer in the boardroom as it is anywhere else in the organization. First and foremost, boards should approach the issue as a critical enabler to long-term value creation, assessing the overall mix of skills and capabilities in the boardroom frequently, and taking action as appropriate to enhance alignment between board composition and the future needs of the company. When considered from this perspective, it becomes clear that waiting for natural turnover to occur is rarely the best approach. Age and tenure limits can help force turnover in an objective manner that avoids controversy but alone are not sufficient and should not replace careful assessments, tough decisions, and respectful but timely change when it comes to board refreshment.

Russell 3000 new directors 2013–2017



Source: Equilar Board Composition and Director Recruiting Trends, 2017

What are the most significant changes you expect to see in board composition over the next few years?

Patricia Pineda:
With a greater focus on board refreshment by stakeholders and many current directors reaching board age limits, there will be a wave of retirements, particularly among baby boomer and older directors. This should lead to a new and younger generation of board members. As certain areas, such as technology, grow in importance and relevance to business strategies, I believe there will be a greater receptivity to younger candidates below the CEO level who bring expertise and insights that can help a company remain competitive. There will be an even greater push for diversity of thought, skills, experience, and backgrounds. As more boards work towards becoming more reflective of American and global consumers and diverse workforces, we will see more gender, racial, and ethnic diversity. This diversity will continue to grow as boards and companies embrace the significant value derived from having a diverse board in a highly diverse marketplace. If we look at Latinos as an example, U.S. Latinos are 18 percent of the U.S. population and are projected to grow to 30.2 percent by 2050. They are also the youngest ethnic group in the U.S. and are driving consumption growth for all mass consumer categories. In 2015, the gross domestic product (GDP) produced by Latinos in the U.S. was $2.13 trillion; if it were an independent country, the Latino GDP would be the seventh largest in the world. I believe that U.S. Latino directors not only bring business acumen, experience, and expertise to the board table but also valuable insights into the rapidly expanding U.S. Latino consumer market.

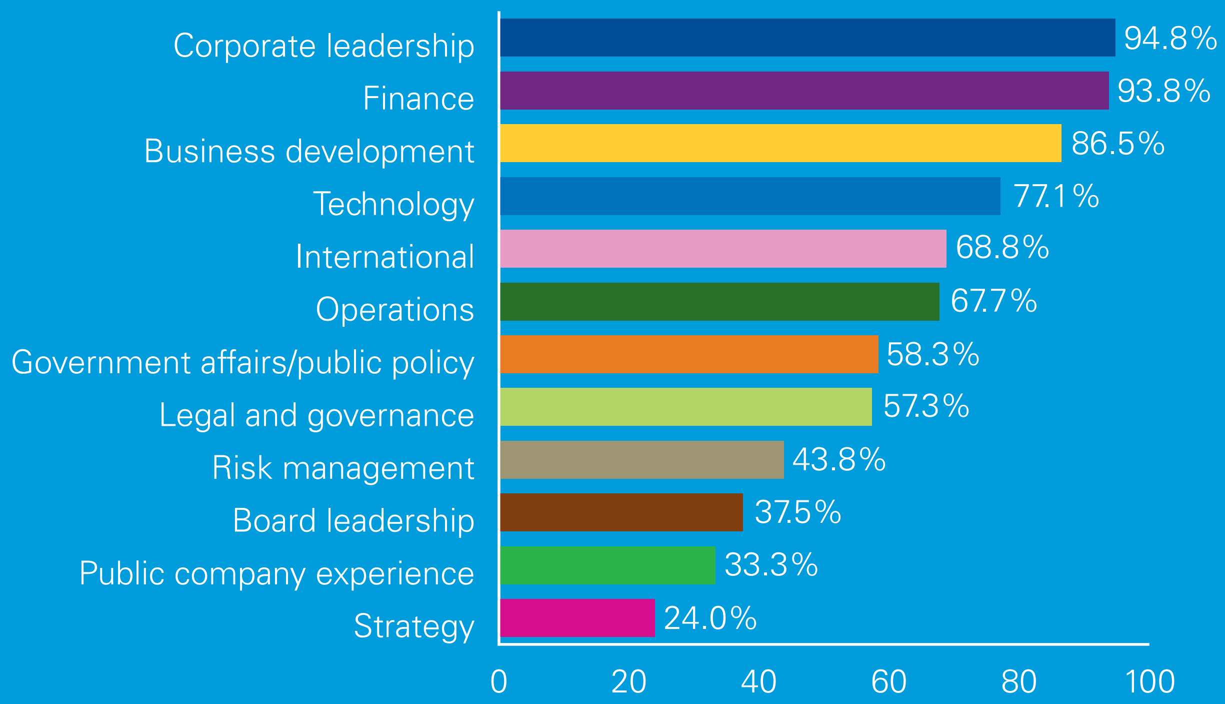
Jared Landaw:
In order to help companies stay competitive in today's challenging global markets, I expect the composition of boards to become more carefully curated over the next few years. Thoughtful nominating committees will focus on ensuring that the directors in the boardroom have the right mix of backgrounds, skills, and experiences to meet the company's strategic and operating needs, ensure that decisions are well made, and provide the management team with guidance on the myriad of issues that the company will inevitably face. After all, a board of directors is a governing body that is designed to work together as a team. If it is going to perform at its best, it will need to be put together like one, by carefully recruiting directors with complementary skills.

Belen Gomez:
Investors are influencing, and will continue to play a major role in, how boards think about and approach board composition processes. We'll see more proposals and engagement on the topic. We've already seen investors such as CalPERS, CalSTRS, State Street, and others taking action. They have great visibility and influence to create impact through their voting policies. We'll also see more deliberate action from the issuer community to increase diversity. We see more and more companies committing to diversity goals for both gender and ethnic representation in the coming years. As more directors age off of boards, we'll see a more diverse group of new directors joining from the current executive ranks.

Blair Jones:
The overall look and feel of boards will change as boards continue to work to attract a more diverse set of candidates, in terms of race, gender, and cultural background as well as experiences, broadening to include more customer and stakeholder insights as well as digital and technology experience. Boards are likely to have higher age spreads, more international representation, and more representation of women and minorities.

Susan Angele:
Tech, tech, tech. The importance of technology to every company is already driving change in the boardroom. Whether it's an understanding of technology-driven disruption, cybersecurity oversight, the workforce implications of automation and artificial intelligence, or having the knowledge to probe and challenge the overall efficiency of a company's technology-related capital allocation, well-rounded executives who understand technology are a hot commodity in the boardroom, and this trend is likely to accelerate as older directors reach retirement age or tenure limits and new board members are recruited. This will likely lead to a younger pool of first-time board members, given that executives often reach a board-appropriate level in their careers earlier in the tech industry than in other industries. And on some boards, this may eventually have a snowball effect. When one director has expertise in technology, they become the board technology expert. When numerous board members have a comfortable understanding of technology and its implications, the overall tenor of strategy discussions may change and over time, this can influence overall board composition. This would take more than a few years, but I can envision a time when all board members are expected to have some level of technology literacy.

Top board skills disclosed by Equilar 500 companies in 2017



Source: Equilar Board Composition and Director Recruiting Trends, 2017

With regard to board diversity, why do you think that progress continues to be slow, and what would help move the needle?

Patricia Pineda:
Progress on board diversity continues to be slow for many reasons. The most apparent reason is that people tend to select others who resemble themselves. If a board lacks diversity, which most do, then that lack of diversity is more likely to be perpetuated. I would couple this with lack of exposure to highly qualified and experienced or board-ready Asian, Latino, African-American, and female candidates. Another reason for the slow progress is that many companies and boards do not fully appreciate the valuable insights and contributions a diverse board can bring in a rapidly evolving and highly diverse consumer marketplace and how this can lead to improved financial performance. Finally, there continues to be a preference for former or current CEOs and CFOs. There are many qualified diverse candidates at the C-suite level who aren't necessarily a CEO or CFO.

In terms of helping to move the needle, boards should broaden their candidate criteria and networks for finding new board candidates. Groups such as Ascend/Pinnacle, the Latino Corporate Directors Association, WomenCorporateDirectors, the Thirty Percent Coalition, the Hispanic Association on Corporate Responsibility, the Executive Leadership Council, Catalyst, Quorum, and the Black Directors Conference are advocating the importance of greater diversity from a business standpoint. These organizations also host events to introduce members, who are experienced directors and board-ready C-suite executives, to CEOs, board chairs, nominating and governance committee chairs, and search firms. I also strongly believe that key stakeholders, such as shareholders and investors, can and should play a critical role in advocating for greater board diversity to advance the economic interests of the company where necessary.

Findings of a 2015 McKinsey & Company report entitled "Why Diversity Matters" indicate that companies in the top quartile for racial and ethnic diversity are 35 percent more likely to have financial returns above their respective national industry medians, and companies in the top quartile for gender diversity are 15 percent more likely to have financial returns above their respective national industry medians. Noteworthy is that companies in the bottom quartile both for gender and for ethnicity and race are statistically less likely to achieve above-average financial returns than the average companies in the data set. In other words, as the McKinsey report puts it, "bottom-quartile companies are lagging rather than merely not leading."

Jared Landaw:
Despite all the attention that has been given to the topic of board diversity in recent years, the number of directorships held by women remains disappointingly low, and progress in increasing gender diversity—while improving—is still much too slow.

In order to move the needle, boards need to work harder and in new ways to improve board diversity. A recent director survey revealed that nominating committees still rely heavily on board member and management recommendations as sources for identifying new directors. Boards should no longer solely rely on their own networks and other well-worn recruiting tools to identify director candidates that tend to perpetuate the status quo. They must cast a wider net and source candidates through new channels. Doing so will inevitably assist boards in improving diversity as the pool of director candidates is expanded by the addition of qualified individuals who may not have been considered in the past.

Belen Gomez:
It's a combination of many factors, both internal and external. First, consider the composition of boards today and the rate of turnover. The size of boards has not changed on average over the past several years, and turnover is still only about one seat per company on average. So, you have an issue with the supply of available seats, which has generated much discussion around the need for more meaningful term limits. Most companies do have an age limit (retirement policy), but we see the average age of retirement increasing slightly each year, and it's typically between 72 and 75 years of age. In our latest Board Composition Trends study, the average age of new directors was 57. That's potentially a 20-year run on any particular board. That's not always the case—average tenure is about eight years—but it does illustrate that board positions are long-tenured with little turnover.

Then there is the "typical profile" of what boards look for in a new director. Although we see many companies making efforts to move away from looking only for current or former CEOs, that's still one of the leading search criteria. There are few women serving in those positions. It's more of a cultural and pipeline issue at the executive level and a lack of women and minorities serving in those stepping stone positions. To clarify, there is no shortage of qualified women or minorities available and interested in serving on boards. However, if boards only look for experience at a particular title level, they are eliminating an entire pool of candidates who could be just as well-qualified with different skill sets and experiences.

Lastly, I'd note that the preparation of aspiring director candidates needs to start early. Anyone interested in board service, including women and minority executives, should seek mentors, expand their networks, and ensure professional development opportunities. Basically, they should take every opportunity to educate themselves on the role of director and making their interests known.

Blair Jones:
There is a lot of truth to the saying that "What gets measured gets done." There has been good discussion and prominence given to the issue of board diversity through the myriad organizations such as the U.S. 30% Club, the Committee for Economic Development's Every Other One Initiative, WomenCorporateDirectors, Latino Corporate Directors Association, and Ascend. Because of these organizations, the pool of diverse candidates is more prepared and more visible, and the topic of board diversity has gotten much more prominence and discussion, both inside the boardroom and out. However, State Street raised the bar this year when it said it would vote against board members involved in board nominations for boards that had no women and showed no efforts to increase diversity—and it followed through. As a result, the measurement has moved from a trend to an expectation. As more institutions lend their weight to this issue, we expect the needle will move.

Susan Angele:
The talent is available, but moving the needle will require more boards with (1) an opening in the boardroom, (2) a strategy of including diversity as an important criteria in a board search, and (3) openness to recruiting board candidates who are highly qualified but not CEOs or experienced board members. Without significant movement in these areas, the likelihood that the rate of progress will change is low. In addition, while progress on gender diversity is slow, progress on other measures of diversity—ethnicity, sexual orientation—is not even part of most discussions.

A focus on the second consideration is the most likely way that the needle will realistically move. One reason diversity might be considered an important criterion in a board search would be that a leader in the boardroom views it as a priority, particularly in light of research linking diversity to long-term value. And anecdotally we've seen how the makeup of a candidate pool can change dramatically if the nom/gov chair or another board leader insists on diversity. Another reason diversity might be considered important would be external pressure. In this regard, a couple of the largest institutional investors have begun to take a more aggressive, less tolerant approach to boards without any women. It will be interesting to see how much that moves the needle. And while slow, generational turnover itself may help. In a 2016 survey by WomenCorporateDirectors, Spencer Stuart, and Harvard Business School, older (over 65) male board members were more likely to perceive a lack of talent as the reason for lack of diversity, whereas younger (55 and younger) male board members viewed the issue as a lack of priority (42 percent versus 22 percent).

What do you think companies should communicate to their investors about the composition of their board?

Patricia Pineda:
A significant percentage of shareholders are big investors, including public pension funds, many of whose members and beneficiaries are women and minorities, particularly if we look at states such as California, New York, Texas, and Illinois. These investors are increasingly scrutinizing the board diversity of companies in which they are investing and calling for greater board diversity. I think it's in companies' best interests to get ahead of the curve on this. Companies should proactively communicate to their investors how their board's skills, experiences, and diversity align overall with the business, its consumer base, and any plans to improve upon diversity.

Jared Landaw:
Shareholders have an interest in not only understanding the background and experience of directors, but also why they were selected and how the overall composition of the board will help facilitate long-term value creation. Many institutional shareholders have also expressed a desire for companies to clearly disclose the gender, racial, and ethnic characteristics of director nominees, as board diversity has become an important factor influencing their voting decisions. To that end, it is encouraging that approximately one in six companies in the Equilar 500 elected to include a board matrix in their 2017 proxy statements, up from approximately one in eight companies in 2016.

Belen Gomez:
Boards should communicate the qualifications of board members and the level of expertise they bring to the table. There are many ways to do this, whether through the bios/skills, or a matrix format. I believe shareholders would also like more detail on how boards are evaluating new candidates for board service and the processes by which they recruit, beyond boilerplate language.

Blair Jones:
Companies should communicate the link between their business priorities and the skill sets they have focused on in populating their boards. It is also a good idea to talk about how needed skill sets are evolving, and how the company will use board succession to replace skills of retiring directors and attract directors with skills in newly relevant areas. Helping investors understand the range of skills targeted and how they complement each other (through a skills matrix or otherwise) connects names and biographies to the underlying business needs.

Susan Angele:
I thought it was telling that Equilar's new report shows an increase in the number of companies that are including a board matrix in their proxy disclosures. Corporate governance has reached an inflection point in the balance between boards and shareholders. With respect to board composition, institutional investors expect communication, engagement, and—as it relates to gender diversity—progress. Large and influential institutional investors, including State Street and BlackRock, have indicated that they may vote in favor of a shareholder proposal or even against the reelection of a director as a means of holding companies accountable if they do not have confidence in the board's practices in this area.

What about the key findings of the 2017 Equilar Board Composition and Director Recruiting Trends report surprised you the most?

Patricia Pineda:
What surprised me the most is the absence of data regarding Asian, Latino, and African-Americans, particularly given the underrepresentation of directors who bring racial and ethnic diversity to the boardroom and the growing importance of diverse consumers and markets.

Belen Gomez:
One of the more surprising trends we see is the continued decrease in the average age of new directors. It's down from 60 just three years ago, now at 57. It's indicative of boards broadening the candidate pool and recruiting the next generation of executive leadership.

Blair Jones:
I am most surprised by the low level of representation of women in leadership positions on boards. The data shows that women serve in 20.9 percent and 16.0 percent of Equilar 500 and Russell 3000 board seats, respectively, but only 8.4 percent of board-level leadership roles are occupied by women in the Equilar 500—a figure that sits at 5.6 percent in the Russell 3000 in 2017. Boards need to continue to be vigilant in both increasing the number of women on boards and elevating them to leadership positions to more fully realize the benefits of women directors' diverse experiences, backgrounds, and thinking.

Susan Angele:
The Russell 3000 statistic of average number of women on boards, by sector, is the most surprising. With one exception, every single industry sector had an average of fewer than two women on the board, and every single sector except one saw an increase from 2016 of only one. It's a stark illustration of how slow the progress really is.

Additional reading

Board composition and director recruiting trends

Bringing the diversity discussion into the compensation committee

Building a great board

Seeing far and seeing wide: moving toward a visionary board

KPMG Board Leadership Center

The KPMG Board Leadership Center champions outstanding governance to help drive long-term corporate value and enhance investor confidence. Through an array of programs and perspectives—including KPMG's Audit Committee Institute, the WomenCorporateDirectors Foundation, and more—the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement of public- and private-company governance. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers practical thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens.

Learn more at kpmg.com/blc.

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