Boyden

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Board of Director Series

The Changing of the Board

Part Two: **Better Directors for Better Boards**

Seeking more capable directors is one key to improving board performance.

Boards can only be as strong as the people who serve on them. Companies must work harder to find and recruit a new generation of board members who are better qualified for proactive and collaborative approaches to corporate oversight, strategy and risk management.

Boyden global executive search

with

John Levy, Board Advisory

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I Introduction:

Finding the next generation of directors

"Boards are looking harder at who they need versus who they have."

Trina Gordon
Chairman, Boyden World Corp.
Managing Director, Boyden Chicago

The world of boards and directors has changed. Business conditions are more volatile and complex. Board work is more demanding. Accountability is the new reality.

After the Enron scandal, boards of directors were made more independent from company management. Board committees were given clearer responsibilities and greater access to external resources. Tougher standards were defined for board membership.

In addition, since the passage of Sarbanes-Oxley, boards have had to become more professional and productive. When companies consistently make critical mistakes, commentators and analysts focus on board failures. They talk about board leadership, structure, policies, and decisions. They will talk about how the CEO is performing. But almost no one talks about the competence of individual members of the board: the directors.

Rather than being seen as the building blocks of a board, directors are too often considered simply "cogs" in a collaborative machine. That's because the powers of the board are invested in the board as a whole, not in individual directors. But anybody who has worked closely with a board knows that each director has specific duties. The failure of any individual director to pull his or her share of the load rapidly sub-optimizes board performance as a whole.

Individual directors continue to struggle with the size of the task, the lack of transparency, and too often, the conflict between management agendas and shareholder value. As a result, many problems are still visible. Shareholders are outraged, for example, by the failure of boards to limit executive compensation. Directors complain that increased compliance work leaves them little time to focus on strategy and the road ahead. It is also undeniable that boards failed to provide sufficient risk management to mitigate the global economic crisis of 2008.

It's time to ask if the current models (and requirements) for board membership are sufficient.

Traditionally, companies have spent less on recruiting directors than on executive search; CEOs and boards have recruited from the network of people they already know. While recruiting from familiar contacts ensures a more predictable board experience, it limits opportunity, diversity, and inevitably, director independence.

Research data indicates that increasing director independence is the single most important factor in enabling boards to improve shareholder value. RiskMetrics Group, a provider of corporate governance services, reported that in a recent overview of board structure trends of S&P 1,500 Companies, "board independence continues to rise, increasing four points to 78 percent in 2008, as companies maintain fewer affiliated directors" and that more companies were separating the roles of CEO and Chairman of the Board. This is another step towards empowering independent directors, but does not assure independence of mind. Many independent board members are still influenced by the fact that they were appointed by a CEO or because of business relationships with the company.

Competing for the future now includes competing for directors.

When serving on boards was largely ceremonial, it was easy to find candidates. As the bar is raised for qualifications, however, there will be more demand than supply for the new generation of directors.

In addition to having traditional director attributes of experience and seasoned judgment, the next directors must know how to operate successfully in today's more connected world. They need to bring expertise in important new competencies like digital branding and business continuity.

The next generation of directors must also be "un-conflicted" about shareholder value when considering all board decisions.

Thus, companies will need to increase their investment in recruiting and training future directors, and continue to educate and support them throughout their board service. This means rethinking board succession practices. Traditionally, boards have relied on existing relationships when recruiting new members. Developing true independence will require a more comprehensive approach.

About Boyden's Series on Corporate Boards

The Changing of the Board is a series of four papers about the challenges of finding new directors suitable for today's business environment. These papers explore the critical need to improve corporate oversight and governance in a world of change – and how to accomplish this essential task.

The first paper, **Boards in Crisis**, focused on the past, present and future of corporate boards. It explored the reasons, both historical and contemporary, why shareholder interests have not received the attention they require – especially in the context of the recent global crisis, wherein boards' failures to manage risk and compensation in financial services indicated a need for deeper and more thoughtful changes in the practice of corporate oversight and governance.

This second paper, **Better Directors for Better Boards**, focuses on the role of the director, and its evolution from a ceremonial and social position to one that is functional and demanding. Getting boards on a new track requires developing the next generation of directors; this paper identifies an updated set of qualifications and recruiting methods for them.

The third paper, **Why Ethics Is Not an Option**, will explore the imperative for every director to understand and utilize ethical frameworks. An interview with John F. Levy, CEO of Board Advisory, explains why returning to ethical frameworks is essential to restoring shareholder trust. Levy details how the value of ethics programs to rebuild customer trust and company reputation far exceeds the cost of such initiatives.

And the fourth paper, **Boards and Corporate Governance**, will identify areas of corporate governance best practices on which boards must focus, such as risk assessment, anti-fraud controls, and readiness for responsibilities.

II The Director's New Job

How board membership is changing

"The job of director has changed significantly."

Thomas Flannery
Managing Director
Boyden Pittsburgh

The job of the board director has always been to protect shareholder interests. But for centuries that job was largely advisory and often ceremonial. Then, in 1971, Harvard Professor Myles Mace published ***Directors, Myth and Reality.*** Myles's book revealed that directors were often marginalized in corporate governance. It described how boards were unable to get accurate information, had limited access to management to discuss critical issues, and rarely participated in choosing CEOs.

Things have changed since then.

Over the last 35 years a series of reforms have transformed the job of director from ceremonial to functional. Today independent directors of public companies are legally responsible to do their duty for shareholders. That includes defining company direction, overseeing management, operations, strategy and results. They are expected to do whatever can be done to grow shareholder value. But that is not always easy in tumultuous times.

"The job of the director has changed significantly," explains Thomas Flannery, Managing Director of Boyden Pittsburgh. "Serving on a board used to be like belonging to a club. You brought your spouse. You played golf before meetings. Now it's all business," Flannery says. In the time available, directors must review all company operations, comprehend the challenges and dilemmas, and ask tough questions. Finally they must vote to approve or oppose management policies and decisions.

Many consider that the most important tasks for directors are the hiring (and sometimes firing) of CEOs. According to a 2009 Board Practices Study published by the RiskMetrics Group, a provider of corporate governance services, 88 percent of boards surveyed now have a board committee responsible for CEO succession. While CEOs may be reluctant to help plan their departure and replacement, the number of such committees has increased 48 percent since 2006.

Surprisingly, fewer companies are changing CEOs at present. Richard Jacobitz of Liberum Research, which tracks changes in C-Suite assignments, says boards are currently playing it safe and retaining CEOs longer to assure stability in these difficult financial times. CEOs may be staying in jobs because they don't have better places to go. This is not, however, true of board members. Dissatisfaction with corporate performance, share price, and executive compensation has increased shareholder activism. So an increased turnover in board positions is expected.

It is difficult to imagine how independent directors – who may also be running their own companies while simultaneously serving on one or more additional boards – manage to get it all done. "Board members used to work 40 hours a year," says Richard McCallister, Managing Director of Boyden Chicago. "Now it's often up to 180 hours." Boards used to meet quarterly; the average is now eight meetings a year. Add to that travel time, conference calls and preparation. McCallister believes that being a director today is a job that's almost impossible to do well. And some don't. "Often board members miss too many meetings," he reports. "Others attend but haven't completed their homework."

There are many factors contributing to the difficult issues faced by today's directors:

Technology: An overriding factor that continues to challenge directors is the speed with which technology is changing the world of business. The Internet and other networking technologies have reduced time and distance problems but added complexity. Much of what companies do today occurs beyond their walls. Multiple vendors collaborate across global supply chains to generate and support company products. Data functions are being migrated to external "clouds" of commoditized data services. Radically distributed operations are "the new normal," but add difficulty to overseeing enterprise operations and, especially, to managing risk.

The Changing of the Board

Next generation board members should be informed and experienced in the new digital technologies, and experts at harnessing the power of network collaboration. To protect shareholder value, it is essential that boards have directors who understand how to leverage the change and opportunities created by disruptive technologies.

Leaderhip shift: A continuing question: who leads the board and sets the agenda for individual directors? Directors often find themselves caught in the crossfire between company insiders and shareholders. Current legislation mandates a majority of directors on boards of most public companies must now be independent. But old culture dies hard. Many sitting directors owe their directorships to CEOs or other company relationships. Board nominating committees have taken over board succession, but CEOs still meet and approve candidates. As a result, directors sometimes struggle with divided loyalties.

Board size: What about the size of the board in relation to the size of the job? Companies are growing larger, while boards are getting smaller. Studies indicate companies with smaller boards are more successful, in part because communications and collaboration is easier in small boards. The board of Microsoft, for example, currently has only ten directors. But as the number of directors decreases, the work of each individual director grows. That is becoming a problem.

Specialization/committess: Most board functions are carried out at the committee level, leading to assignments that could require more time than full board meeting participation. An audit committee, for example, is responsible for auditing company financials, generating budgets, and investigating financial malfeasance. A compensation committee deals with executive compensation, including controversial bonuses whose increasing size has resulted in "say on pay" initiatives to give shareholders a vote on executive compensation agreements.

Numerous boards are adding risk management committees. Whenever companies have special problem areas, boards may establish new committees to assure issues are resolved. The board of Microsoft, for example, has added a permanent committee on Antitrust Compliance.

Compensation: The job of director is less financially attractive than in the past, due to a shift in the balance of risks versus rewards. Compensation of directors is expected to drop until general business conditions improve. But legal exposure of directors appears to be increasing. Many directors are covered by Directors and Officers (D&O) insurance, but policies exclude coverage for situations involving fraud or other criminal activities. Directors are paying more attention to the reporting and compliance regulations for companies on whose boards they sit.

For these reasons, many board members are having second thoughts about board service. Some are declining to run for re-election. Others are choosing to resign even before their term ends. Microsoft Word now includes a template for a board resignation letter.

The good news is boards have an opportunity to rethink their membership strategy. With more openings inevitable, says Trina Gordon, Chairman of Boyden World Corporation and Managing Director, Boyden Chicago. "Boards are looking harder at who they need versus who they have." Have things changed so much that they should look for a new generation of directors?

III The War for Talent Comes to the Boardroom

How board membership is changing

> **"Board searches should be more like executive searches."**
> *Sarah Stewart*
> *Principal*
> *Boyden Pittsburgh*

What kinds of directors are boards looking for?

And how should they be recruited?

When directors only had to show up to review company policy in order to approve it, the character and capabilities of those directors were not so important. Everything has changed since then.

In a letter sent to shareholders, Warren Buffett wrote that he looks for directors who will be "owner-oriented, business-savvy, interested and truly independent." The quality of director independence is a critical difference between directors of the past and directors of the future. Numerous studies have shown the positive impact of board independence on shareholder results: boards that put the interests of shareholders before the interests of management have been shown to produce up to 8% more value annually.

Similarly, the strength and independence of boards is one of the critical indicators that investors consider before buying stock. To that end, the next generation of directors must be completely unfettered to be able to steer company strategy and operations in ways that will best serve shareholders.

The need for independence, however, must be balanced with a cooperative spirit. Thomas Flannery, Managing Director of Boyden Pittsburgh says boards have become like professional sports teams. "Members must have complementary strengths, and everybody has to work together to win." One reason boards give for drawing members from similar backgrounds and professions is to cultivate a familiarity which minimizes disagreements that could consume the limited time boards have to complete their work each quarter.

In turn, the desire for familiarity, is at odds with the need for boards to embrace diversity. While diversity is treated as a social inclusiveness issue, it is actually a business issue. "You absolutely need to have people who come at issues from different places," says Sarah Stewart, Principal of Boyden Pittsburgh. "You want directors to have had different experiences and to be able to bring many different perspectives to problems." Diversity makes boards stronger. But RiskMetrics, a provider of corporate governance services, reports that in 2008 directors on boards of S&P 1,500 companies remained mostly white and male. Minorities accounted for only 10% of board seats. Only 12% of the directors were women.

The next generation of directors needs to be different, because the world is now different. New directors should be more diverse in terms of gender and race. And as markets and supply chains become even more globalized, boards need to become more international in character. New directors must be capable of carrying heavier workloads than executive directors of the past. They need to be better at sifting through massive amounts of market data and at recognizing and managing risk. In fact, according to Boyden World Corp. Chairman Trina Gordon, management of risk is currently the most sought-after capability for future board members.

Ram Charan seeks character as well as ability. "High ethical standards" is the first requirement he mentions in his book **Boards That Deliver: Advancing Corporate Governance from Compliance to Competitive Advantage**. Other attributes include the ability to provide thoughtful and wise counsel; a history of achievement that reflects high standards; a willingness to be accountable for actions; and a demonstrated commitment to the success of the company. Charan ends his list with "the ability to take tough positions while still being a team player." Many say this is the most valuable attribute for board service and the most difficult to find.

Recruiting the new generation of board members.

It is now clear that, given the growing challenges of board service, there will be an insufficient supply of qualified, available and willing candidates to meet the need for new directors. Essentially, companies must now compete to find and recruit the best candidates: "The War for Talent" has come to the boardroom.

Sarah Stewart, a veteran of more than 300 board placements, says, "Board searches should be more like executive searches. The process needs to be more professional, rigorous, and transparent. It's important to spend the time to do due diligence. Board focus has been on finding candidates whose business experience is relevant to what a company is trying to achieve, and who are aligned with the company's strategic direction.

"However, we need to spend time on the 'behavior' part of being a director," explains Stewart. "What is the personality? What is the track record? How has the candidate dealt with director-level issues in the past? You're looking for the ability to ask tough questions and make challenging observations without bruising or bloodying management or other board members."

CEOs and former-CEOs are considered the most desirable candidates for open board positions, because as Stewart explains, they are more likely to understand the big picture, recognize the challenges and be able to face them in partnership, and require less time to get up to speed. But Stewart cautions that it's difficult to find C-suite candidates who have synergy with the board's business without also having some conflict of interest, because in a global economy businesses expand in so many different directions.

Conflicts of interest are also a concern when examining another traditional aspect of board membership: "overboarding." In overboarding, one person serves on many boards. Originally it was considered an advantage to have a director who also served on other boards, and companies with boards of well-connected directors appear to enjoy higher stock prices.

But as the work required of individual board members has grown, it has become more difficult for directors with multiple board assignments to meet all their commitments. Additionally, in periods of economic crisis, executives must focus more on their own companies, leaving less time for serving on their various boards. So some boards now require that their members refuse additional board opportunities. The new reality, therefore, is that there are actually fewer qualified candidates for board positions as originally thought.

Supporting and perpetuating the new breed of board.

Of course, the work of the changing of the board continues beyond the recruitment of better directors: an ongoing focus on improving education and support for board members throughout the complete lifecycle of board service will improve every director's effectiveness and productivity. Boards should provide professional "on-boarding," a methodology designed for newcomers to a company to introduce them to the culture of the board and company as a whole and prepare them for their duties. In addition, the importance of ethics training cannot be over-emphasized. (Ethics will be discussed further in ***Why Ethics Are Not An Option***, the third paper in this ***Changing of the Board*** series.)

As the new directors become acclimated to their new roles, and workloads increase, directors require increased support. It has been suggested that boards provide a full-time "secretariat" for their directors. There is also a new trend towards having a "professional director" on boards with significant expertise in board service itself. Another relevant trend, at least for larger companies, is to separate the CEO and Chairman positions. This means finding

a Chairman able to collaborate with the CEO yet maintain his or her independence. Former CEOs of other companies are considered ideal candidates as long as they are not competitive with the CEO. Again, Stewart points out, the Chairman must have some synergy with the business and be knowledgeable about that industry. It is the Chairman's role to decide what the board will work on, supply the information required, and provide the impetus to stay focused at the right level.

It's important to note, though, that separating the role of CEO and Chairman does not assure board independence. For example, until recently the Chairman of Intel's board was always the former CEO. The RiskMetrics survey shows that only 48% of non-CEO board chairs were considered independent in 2008 – 17% more than in 2006. Boards need to recognize that recruiting a new Chairman of the Board, complicated by issues of independence, is almost as challenging – yet as important – as finding a new CEO.

Going forward, Stewart believes boards need to spend more time on board succession. It's a daunting task: finding capable candidates who can meet the fundamental ethical requirement; fill the requirements of committee assignments; and continue to grow and become experienced board leaders – while remaining independent and free of conflicts of interest. There's a more comprehensive process that can be best explored by partnering with a retained search organization whose strategic approach can help organizations rethinking and rebuilding their boards. It's no coincidence that investment advisors now assign great value on companies who have in place a well-defined process for board succession.

A director's value to the board can increase over time, especially when improved support and ongoing education systems can improve retention of critical participants. That being said, the long-term goal of every board should be (in addition to growing share value) to assure the company can and will outlast the service of any individual contributor. And just as recruiting better directors is essential to building better boards, director continuity creates an irreplaceable asset for optimizing board performance and company success. That is the basis for the enduring strength of public companies and capital markets.

Interview with Director X

What happens in boardrooms when times gets tough?

"Keep adding risks and liabilities for board members, you'll find fewer people willing to serve on boards."

Director X, independent board member

Director X agreed to talk with us about how boards really work. He reveals what happens behind closed doors when it's time to make tough decisions. He talks about how Sarbanes-Oxley changed what directors do. And he explains why the role of CEOs on boards had to change.

Director X is the CEO of a Midwestern US company who currently serves on four boards of companies listed on the New York Stock Exchange. To honor the code of confidentiality that enables honest and open discussion between board members, his identity has been protected.

Boyden: The economic meltdown of 2008 thrust the boards of companies in crisis into the spotlight. You were on the board of a financial services company where it all came down to one meeting, one decision, one vote. What was that like?

Director X: *Absolutely the toughest board meeting I ever had.*

Boyden: Why?

Director X: *The company had taken on too much risk. They were in too deep. It came down to either take the company bankrupt or take a deal offered by the government. Some directors thought going bankrupt would benefit shareholders. My view was you have to consider your customers and your employees too.*

Boyden: How did the board vote?

Director X: *I'm not going to talk about the specific votes, but it wasn't unanimous. We went with the government offer. Ultimately I think it was the right decision.*

Boyden: Could the board have prevented this by acting sooner?

Director X: *We needed to fire the CEO a long time ago. I argued for that. But what can you do if the other directors don't agree? How do you fire someone when profits are so high, and shareholders are doing well? And of course there was a lot of resistance from management.*

Boyden: Is it any easier on your other boards?

Director X: *All the boards I'm on are going through some sort of crisis.*

Boyden: What happens in boardrooms when things get tough?

Director X: *Every board is different. I mean they're all in different businesses. But what they all have in common is… you're in the foxhole with all these other directors, and you all work together as a team. You surround the issues that need to be surrounded.*

Boyden: What is a board member's most important asset?

Director X: *Your most important asset is your fellow board members. You depend on what they each bring to the table from their different life experiences. I'm a big believer in the power of diversity making boards stronger.*

Boyden: Is there anything that happens in boardrooms the rest of the world never hears about?

Director X: *The really important decisions are usually based on what happens in our executive sessions with the other outside directors. We lay everything on the table. We say, hey, here are some issues that are keeping me up at night. Tell me what your thoughts are.*

Boyden: How did Sarbanes-Oxley change boards?

Director X: *Many believe Sarbanes-Oxley was too much regulation, but it forced boards to stop being passive and become more engaged. That is a good thing.*

Boyden: Do you see more regulation ahead as a result of what happened on Wall Street?

Director X: *If we get any more engaged, we'll be running the company. And that's a crazy thing to do.*

Boyden: Are you saying more regulation for governance would be counter-productive?

Director X: *I'm saying if you keep adding risks and liabilities for board members, you'll find you don't have a lot of people willing to serve on boards.*

Interview with Director X

What happens in boardrooms when times gets tough?

Boyden: Does fulfilling compliance requirements get in the way of doing more important work for companies?

Director X: *If you spend more time checking off boxes, you have less time to talk about strategy. The number one issue for boards right now is not having enough time to spend on strategic planning and risk. Where should the company be in five years? What are the icebergs out there? A lot of board members are worried about that.*

Boyden: Should the role of CEO and Chairman of the Board be separated?

Director X: *All my boards are moving towards a separate CEO and Chairman. It's a lot of work to set agendas and deal with all the board leadership issues. A CEO doesn't have the time. What you do want, however, is a Chairman and a CEO working closely together.*

Boyden: Last words?

Director X: *No matter what, you've got to do the best job possible for the shareholders.*

Better Directors for Better Boards

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About Boyden

Boyden is a global leader in the executive search industry with more than 70 offices in over 40 countries. Founded in 1946, Boyden specializes in high level board and executive search, interim management and human capital consulting across a broad spectrum of industries. For more information, please visit **www.boyden.com.**

About John Levy and Board Advisory

John F. Levy is Chief Executive Officer and principal consultant for Board Advisory, a consulting firm that assists public companies, or companies aspiring to be public, with corporate governance, corporate compliance, ethics, financial reporting, and financial strategies. Mr. Levy has 30 years of progressive financial, accounting, and business experience, including having served as Chief Financial Officer of both public and private companies.

As a frequent speaker on the roles and responsibilities of board members and audit committee members, Mr. Levy has authored "Focus on Corporate Ethics: Legal and Ethical Responsibilities of Board Members," a course on the ethical and legal responsibilities of board members initially presented to various state accounting societies.

For additional Information about Board Advisory and John Levy, please visit boardadvisory.net.

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