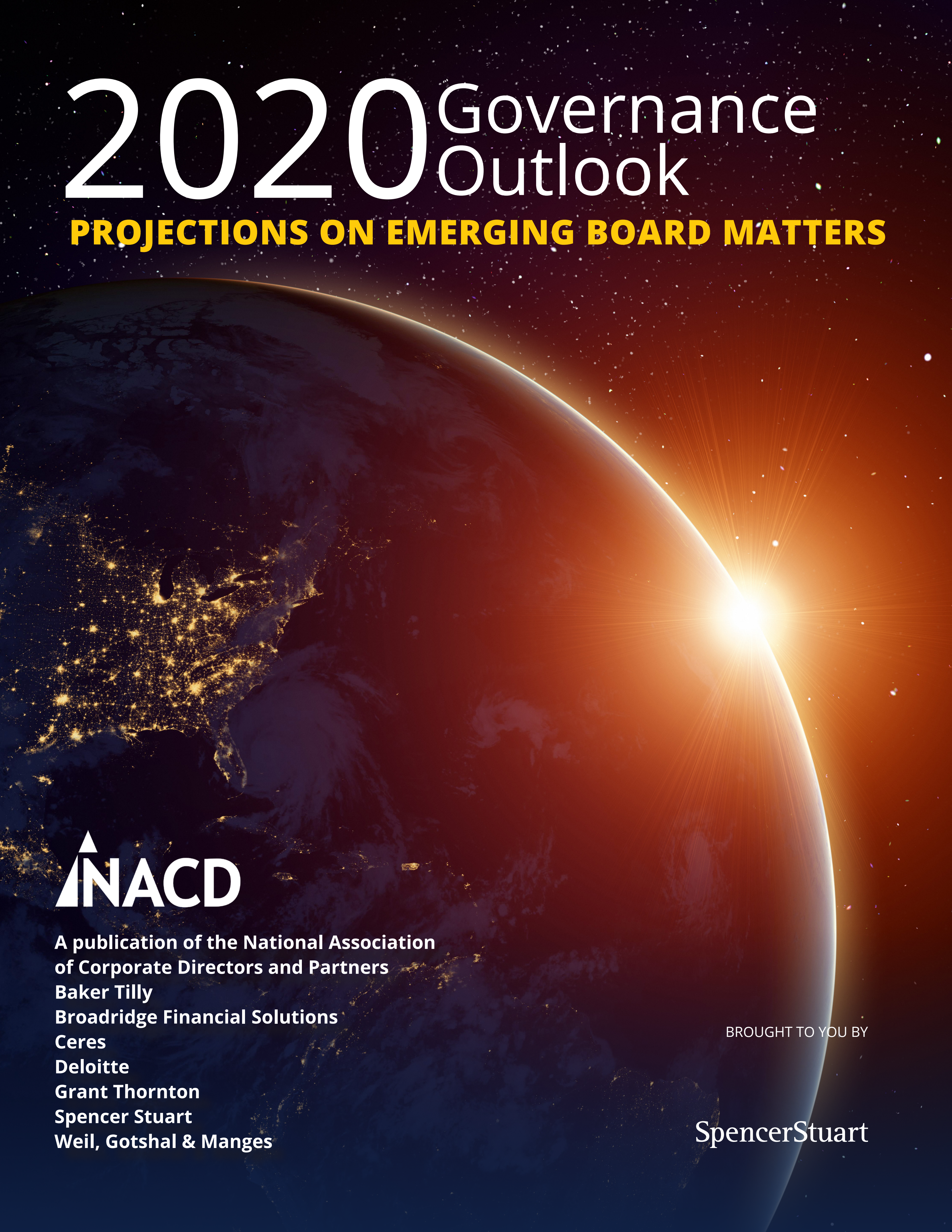

2020 Governance Outlook

PROJECTIONS ON EMERGING BOARD MATTERS

NACD

A publication of the National Association of Corporate Directors and Partners
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ABOUT THIS REPORT

The *2020 Governance Outlook: Projections on Emerging Board Matters* is designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues likely to demand board focus over the coming year. The report begins with an introduction from NACD, highlighting survey findings about leading board priorities for 2020, and follows with eight partner contributions that provide distinct insights and projections on the following themes: preparing for the next recession, strategic business risks, regulatory changes, legal risks, board composition, the digital frontier, ESG and engagement, and water scarcity risk.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2019, and (3) relevant implications and questions for boards to consider. The *2020 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards prioritize their focus in 2020 and increase their awareness of emerging issues, through both detailed topical analysis and coverage of broader governance implications.

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Fresh Perspectives:
Increasing the Diversity of Experience, Expertise, and Ideas in the Boardroom

By Julie Hembrock Daum, Spencer Stuart

In this era of rapid technological change and market disruption, boards have their work cut out for them just to keep pace with what is happening in their own companies, let alone in the broader, converging business environment. To remain an asset to the company—and to be prepared to make a meaningful contribution to enterprise strategy and able to challenge management effectively—boards need to continually consider refreshment and seek out directors who can bring in much-needed knowledge and experience from the front line.

Responding to the evolving demands on boards and a growing investor focus on board composition, many boards are diversifying perspectives in the boardroom. As a result, the profile and skill set of the director continues to shift.

The data presented here is based on our analysis of the most recent proxy statements from 491 S&P 500 companies filed between May 30, 2018, and May 15, 2019, and responses to our governance survey from 113 nominating/governance committee members conducted in the second quarter of 2019.

The following represent the key board trends that Spencer Stuart believes will continue or accelerate in 2020, and how these trends are likely to shape board priorities in 2020 and beyond.

Boards Will Continue to Prioritize Diversity When Recruiting New Directors

Amid pressure from investors, proxy advisers, and, in some states, new regulations, boards will continue to accelerate the addition of women and minority directors to their membership. Proxy advisers ISS and Glass Lewis each have established policies recommending voting against the nominating committee chairs (and potentially other directors) of companies with no female directors, unless certain mitigating factors apply. Several major institutional investors, including State Street Global Advisors (SSGA) and BlackRock, have also taken a stand on gender diversity, voting against nominating chairs when there are no female directors on the board. Going one step further, BlackRock voted against directors, usually the chair or members of the nominating committee, at companies that did not have at least two women on the board and didn't have a clear policy on board diversity or hadn't improved board diversity.[1] Regulators, too, are pressing for progress on diversity. California established gender quotas for companies headquartered there, mandating boards to have at least one female director by the end of 2019 and two to three female directors, depending on board size, by the end of 2021. New Jersey is considering

[1] See Shirley Westcott, "2019 Proxy Season Preview," the *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), April 15, 2019; the ISS press release, "ISS Announces 2019 Benchmark Policy Updates," November 19, 2018; and "ISS and Glass Lewis Policy Updates for the 2019 Proxy Season," *Sidley Update*, November 27, 2018.

similar legislation,[2] while a new Illinois law requires public companies headquartered there to disclose the racial, ethnic, and gender diversity of their boards of directors.[3]

Boards have increased the pace of recruiting women and minority directors. Of the 432 independent directors added to S&P 500 boards in the 2019 proxy year, a record-breaking 59 percent are from these historically underrepresented groups, up from half in 2018. Gender diversity is a clear boardroom priority, with women constituting 46 percent of the 2019 incoming class, compared to 40 percent in 2018. More than 90 percent of S&P 500 boards now have two or more women directors, up from 86 percent in 2018 and 53 percent in 2009.

Racial and ethnic diversity also appears to be a recruiting priority for S&P 500 boards. About one in four new S&P 500 directors added in 2019 (23%) are minorities (defined as African-American/Black, Asian, and Hispanic/Latino), an increase from 19 percent in 2018. Among the top 200 S&P 500 companies, 19 percent of all directors in 2019 are male or female minorities, up from 17 percent in 2018.

Our survey of S&P 500 nominating/governance committee members reveals that increasing diversity, especially gender diversity, will continue to be a top recruiting priority. Thirty-six percent of respondents said their board's highest recruiting priority is adding women directors, the highest of any recruiting profile, and 40 percent said female directors will be the director candidates most in demand over the next three years. Nearly one-quarter (24%) said minority candidates will be in demand over the next three years.

Nominating/Governance Committee Member Survey

Current highest-priority board recruiting profiles	Skills, qualifications, and backgrounds most in demand over the next 3 years
1. Female directors (36%)	1. Female directors (40%)
1. Technology experience (34%)	2. Technology experience (38%)
2. Active CEO/COO (32%)	3. Active CEO/COO (35%)
3. Financial experience (28%)	4. Digital/social media experience (26%)
4. Operational experience (27%)	5. Minority (24%)

2. Jeff Green and Andrea Vittorio, "New Jersey Follows California in Measure to Add Women to Boards," Bloomberg, December 21, 2018.
3. Peter Hancock, "Illinois companies now must report on board diversity," the *Chicago Sun Times*, August 27, 2019.

The focus on increasing gender and ethnic diversity will inject a broader set of functional, industry, and generational perspectives into the boardroom.

For years, investors have been urging boards to look beyond CEOs and experienced directors to find boardroom talent. Boards are now listening. In addition to the increasing gender, racial, and ethnic diversity of new directors, the professional backgrounds, areas of expertise, and ages of directors joining S&P 500 boards will continue to shift. We are already seeing these shifts:

- CEO experience isn't required: 65 percent of the 2019 incoming class came from outside the top executive ranks of CEO, chair/vice chair, president, and chief operating officer.
- Functional and other corporate leadership experience is valued: 23 percent of new independent directors in 2019 have experience as division/subsidiary heads or as executive vice presidents, senior vice presidents, or functional unit leaders.
- Board experience isn't a requirement: 27 percent are serving on their first public-company board.
- Age diversity is a lower priority: 16 percent are 50 or younger, a small decline from 17 percent in 2018 and 2017.

Women and minority directors are one of the driving forces behind the changing profile of new S&P 500 directors, enhancing the diversity of thought, experience, and expertise in many boardrooms.

Women and minority directors are one of the driving forces behind the changing profile of new S&P 500 directors, enhancing the diversity of thought, experience, and expertise in many boardrooms. The data show differences between the profiles and skill sets of these historically under-represented groups and a traditional director profile. For example, women and minority new directors are far less likely to be CEOs or experienced directors: only 19 percent are current or former CEOs compared to 44 percent of nonminority men, and 34 percent are serving on their first public-company board, nearly double the rate (18%) of nonminority directors.

As a result of their diverse backgrounds, these directors bring different types of leadership and professional experience to the boardroom. They are more likely to be current or former line or functional leaders (31% versus 11% for nonminority men) or to be academics, consultants, or to work in the nonprofit or government/military sectors (18% versus 7%). These directors are less likely to have backgrounds in investment management (7% versus 14%). They also tend to be younger: 18 percent of women and minority directors are 50 or younger, compared to 12 percent of nonminority men.

Low turnover and long tenures will continue to impede meaningful change in overall composition, absent changes in refreshment practices.

While women and minority men represent more than half of the new S&P 500 directors, continued low boardroom turnover remains a persistent impediment to meaningful year-over-year change in the overall composition of S&P 500 boards. As a result, in spite of the record number of female directors in the 2019 incoming class, the representation of women on S&P

500 boards increased incrementally to 26 percent of all directors, up from 24 percent in 2018. In fact, about two-thirds of boards that increased the number of women on a net basis increased the overall size of their board.

Many boards—44 percent—have maintained or reduced their size on a net basis over the past year. Twenty-nine percent of S&P 500 boards made no changes to their roster of independent directors—neither adding nor losing independent directors—and 15 percent reduced the overall size of their boards. On average, S&P 500 boards added less than one new director in 2019 (0.88 new directors per board). Meanwhile, while average director tenure has trended modestly lower since 2015 (from 8.5 years to 8 years), 17 percent of independent S&P 500 directors have served on their boards for 11–15 years and 13 percent for 16 years or more.

Turnover on boards today is largely driven by mandatory retirement, and this is likely to continue to be the case in 2020. Seventy-one percent of S&P 500 boards disclose a mandatory retirement age for directors, but boards continue to raise retirement ages, further entrenching directors. Among S&P 500 companies with retirement-age policies, 46 percent set the age at 75 or older, compared with just 15 percent in 2009. Four boards have a retirement age of 80.

Board demographics suggest turnover will remain low, as only a small percentage of sitting independent directors are approaching retirement age. Just 15 percent of the independent directors on boards with mandatory retirement policies are within three years of the age cap. With these directors averaging 63 years of age, most S&P 500 directors have years of potential service before reaching mandatory retirement.

The Implications for your Board

Business demands and investor pressure are influencing boards' composition and refreshment strategies. Boards can use the following recommendations to enhance short- and long-term approaches to their composition:

Assess Skills and Incorporate Results From Performance Assessments Into Board Succession Planning

Investors increasingly are looking at individual director commitment and performance. To do so they are analyzing the number of boards a director serves on, director meeting attendance, tenure, and the overall relevance of directors' skills to the needs of the business. Many have their own definitions of overboarding or excessive tenure. They consider meaningful full-board, self-, and peer assessment as a best practice for evaluating and enhancing board performance and promoting boardroom refreshment.[4]

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[4] See *Proxy voting guidelines for U.S. securities*, BlackRock, January 2019; *2019 Proxy Voting and Engagement Guidelines: North America*, State Street Global Advisors; and "ISS and Glass Lewis Policy Updates for the 2019 Proxy Season," *Sidley Update*, November 27, 2018.

In fact, board performance assessments are a widespread practice. Nearly all S&P 500 boards report conducting some sort of annual performance evaluation, and, more recently, individual-director evaluations have started to gain traction. Forty-four percent—up from 38 percent in 2018 and 22 percent 10 years ago—report some form of individual-director evaluations in their proxies.

The most effective boards use the results of board and individual-director assessments as a fundamental element of strategic board-succession planning. They also consider whether the skill sets and profiles of current directors are still relevant in light of changing business needs and the future of the business. Considerations include a mix of age, experience, and background among the board to help foster better debate and decision making while avoiding groupthink.

Set Expectations Around Tenure

Recognizing the importance of regular board refreshment, savvy boards openly discuss and forge agreement on both appropriate director turnover and refreshment and how they will be achieved. Board leadership sets the tone about the length of director service at the outset, ideally ensuring that directors understand that renominations are not simply assumed—they are based on the current needs of the board to effectively oversee the company's evolving strategy, and require the sustained high performance of individual directors.

In addition to setting clear expectations around director tenure, boards should periodically assess whether tenure-limiting policies are appropriate. Most boards rely on mandatory retirement policies to promote turnover. In some cases, boards make exceptions to mandatory retirement ages to keep a particular director on the board. This can become problematic, as it can set a precedent for all future directors nearing retirement age. Another tenure area that boards can focus on is the optimal mix of board-tenure levels or aggregate board tenure. Some boards seek to balance their composition with a mix of tenures that includes new directors, directors with medium tenures, and directors with long tenures.

Embrace a Continuous Improvement Mind-Set

High-performing boards assess the culture and dynamics in the boardroom to understand how they can operate more effectively. They use annual assessments to understand the performance and contributions of the board as a whole and those of the individual directors. These boards view composition as a strategic asset and take a formal approach to board refreshment, taking a multiyear view of departures and using assessments to strategically plan for board openings.

To make the most of the increasingly diverse perspectives in the boardroom, boards should define and manage a board culture to facilitate constructive interactions between board members. For boards striving to be more dynamic, performance oriented, and shareholder focused, getting culture right is key.

BOARD OVERSIGHT QUESTIONS

- What mechanisms are we using to ensure board refreshment?
- How frequently are we conducting a side-by-side comparison of directors' skill sets and experiences against the company's strategic agenda?
- Have we fostered an environment that encourages individual directors to think critically about their contributions and the relevance of their skills to the company strategy?
- Are we effectively using our annual board assessment and regular executive sessions to consider the culture and dynamics in the boardroom and ways to operate more effectively?
- Have we clearly communicated with investors that we have a process in place to ensure that our current board is the best fit for the future of the business?

Julie Hembrock Daum leads the North American Board Practice and was a long-standing board member of Spencer Stuart. She consults with corporate boards, working with companies of all sizes from the Fortune 10 to pre-IPO companies. She has conducted more than 1,000 board director assignments, recently recruiting outside directors for Cargill, Domino's Pizza, Marsh & McLennan, US Bancorp, Saudi Aramco, Nike, numerous IPOs, and spin-off boards.