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A NEW ROLE FOR THE ANNUAL BOARD EVALUATION

INFORMING DIRECTORS, GIVING THEM A VOICE AND OPENING A WINDOW INTO THE BOARDROOM.

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Shareholders are scrutinizing the composition and activities of corporate boards more carefully than ever before. Board-centric annual meetings have become a showcase for director accountability and a referendum on the board's policies and performance. Board effectiveness and accountability have overtaken compliance as the quintessential corporate governance issue for shareholders voting their proxies at annual meetings. Director elections, even when uncontested, are no longer routine.

The era of technical governance reforms that lasted more than 30 years has largely run its course. External best practice standards are well established and no longer in dispute. With the exception of a few remaining skirmishes over issues such as shareholder access and dual class voting, there appear to be no new governance reform initiatives in the works. Instead, companies are facing a growing challenge in the form of shareholder activism that questions how effectively boards are implementing governance policies and how well companies are performing. Taking the lead from activists, shareholders and their advisors are scrutinizing board composition, director qualifications, the quality of the board's decisions and their links to the company's strategic goals and long-term financial performance.

The shift to boardroom accountability should come as no surprise. It is the logical outcome of multiple factors that have shaped governance reforms and relations between companies and shareholders during recent years. These factors include:

- shareholder activism in part triggered by the governance missteps of directors that focuses on financial performance, business strategy and board accountability rather than just compliance with governance norms;
- stewardship codes that require institutional investors to exercise greater diligence in monitoring portfolio companies and voting proxies in director elections;
- growing awareness that environmental, societal and governance (ESG) issues and other non-financial risk factors can have a significant impact on a company's sustainability and financial performance;
- the convergence of investor relations and corporate communications around board-level issues, in some cases reflecting an intentional blending of governance and branding strategies;
- loosening constraints on communication between directors and shareholders in the wake of successful say-on-pay engagement campaigns;
- dissatisfaction with the quality of disclosures by companies in voluntary "comply-or-explain" governance jurisdictions and demand for more informative and substantive narrative explanations; and
- the Integrated Reporting movement and accompanying efforts to introduce holistic management techniques and reporting under the oversight of the board of directors.

These developments have fueled an increase in activist campaigns that focus on business strategy and board effectiveness. The strategic questions asked by activists – and often by long-term shareholders following the activist lead – require answers from the directors as well as the management of targeted companies.

In an effort to increase transparency about board activities, companies have introduced a variety of different types of communication. Detailed corporate governance policy statements, reports on ESG topics and annual letters from boards explaining how they are fulfilling the company's mission are increasingly common. Integrated summary annual reports are also being tested as a means to provide shareholders with business narratives that incorporate both board-level issues and financial results.

CURRENT BOARD EVALUATIONS

The annual board evaluation has even greater potential to shed light on boardroom activities.

Because board evaluation is virtually unregulated, companies have a great deal of flexibility with respect to both the process and its disclosure. The rules governing board evaluation are straightforward and non-prescriptive. New York Stock Exchange section 303A.09 states: "The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively." The UK's Corporate Governance Code goes further, requiring the annual report to explain "how performance evaluation of the board, its committees and its individual directors has been conducted" (section B.6.1). It also requires that "board evaluations of FTSE 350 companies should be externally facilitated at least every three years, and any other connections between external consultants and the company disclosed" (B.6.2). Other important markets, such as Japan, have introduced board evaluation requirements with the objective of encouraging companies to meet global governance standards and thereby improve their productivity and economic performance.

Current board evaluations do not take advantage of the flexibility offered by minimal regulation. Instead, they focus on core legal and procedural matters: board committee structure, organizing documents, governance policies, numbers of meetings, attendance records, peer benchmarking, director independence, diversity, age, tenure and contributions to the board skills matrix. They utilize detailed questionnaires for benchmarking and personal interviews to explore sensitive matters, such as the conduct of an individual director, the board's relations with the CEO and internal boardroom dynamics. The process resembles an annual physical exam where doctor and patient participate in a private diagnostic review.

Reporting requirements for board evaluations have also been narrowly construed. Most companies go no further than disclosing in their proxy statement that the evaluation has been conducted. Details of the process, its findings and any remedial actions taken by the board are generally not disclosed. Privacy and confidentiality take precedence.

There is extensive professional commentary in support of this limited concept of board self-assessment. Corporate governance practices must meet regulatory requirements and boards need to understand how their policies compare with peer companies and best practice standards. Privacy and confidentiality are necessary to ensure that sensitive tasks such as the evaluation of an underperforming individual director will be undertaken rather than avoided.

However, there are also risks. A board evaluation that focuses exclusively on compliance and procedural matters may over time become a repetitive and formalistic box-ticking exercise. It may overlook issues that are important to external constituencies not present in the boardroom. Further, disclosure that contains no detail cannot answer shareholders' persistent questions about board qualifications and effectiveness.

A MORE ROBUST EVALUATION PROCESS IS POSSIBLE

A private diagnostic session does not have to be the exclusive model. The annual evaluation can be anything the board of directors and management want it to be. Since regulatory mandates give companies a virtual carte blanche, companies can exercise tight control over both the process and its disclosure. They have discretion to design an evaluation that is appropriate for their particular circumstances, to decide what issues merit their attention and to disclose as much or as little information as they believe is needed for an informative and convincing narrative.

They have flexibility to avoid the major concerns about greater board transparency: how to exceed regulatory limits on disclosure without incurring liability; how to safeguard confidential strategic information from competitors; how to avoid market confusion that may result from multiple voices speaking on behalf of the company; how to maintain collegiality, privacy and trust that are essential to effective board function.

Boards considering a more robust approach should ask several questions: Could the evaluation process make them better informed about the constituencies they represent? Could it help them understand how their conduct is viewed from perspectives outside the boardroom? When the risk of activism is rising – due to poor financial performance, a weak board, dissident shareholder resolutions, noncompliant governance, scandal, executive turnover, related-party transactions, or similar issues – could companies respond more effectively to these challenges or even avoid them by means of a more substantive board evaluation? In short, could a more comprehensive board evaluation process be an effective means for directors to improve perceptions, increase trust and minimize, if not avoid, confrontation and activism?

If the board answers these questions affirmatively, its plan for a comprehensive board evaluation should ask two additional questions: What constituencies are most affected by the board's current activities? What information does the board need in order to understand and respond to the expectations and concerns of these constituencies?

SHAREHOLDERS AND OTHER CONSTITUENTS

The first and most important constituency for boards is the shareholders. They elect the directors, provide investment capital and technically "own" the company. Shareholders are not a homogeneous group. They are constantly changing in response to multiple factors, both inside and outside the company, that influence their perceptions. The class of "institutional investors" predominates at most public companies, but they too are a highly diverse group pursuing a variety of financial goals – long-term, short-term, indexed, actively managed, international, domestic, private equity, pension funds (public, corporate and private), mutual funds, hedge funds, strategic activists, high-speed traders and other specialized investors and speculators. Retail shareholders, banks, brokers, intermediaries and voting agents such as proxy advisory firms are important constituencies that are attentive to boardroom issues. Bondholders and potential future investors, critical to a company's ongoing capital structure and financial health, are audiences whose interests the board should understand.

Since every company has its own unique and constantly changing mix of owners and investors, the board should periodically be provided with surveillance reports covering ownership and market data. Management teams – corporate secretary, investor relations, marketing, customer relations, research and development – gather this information throughout the year from a variety of sources and outside experts. Some of the most important data comes from the annual shareholders meeting. Because the annual meeting is a board-centric event that centers on the election of directors, a wealth of data and insights can be culled from the meeting logistics, solicitation of proxies, vote tabulation, governance roadshows, shareholder communications, engagement campaigns and other activities that peak around the annual meeting process. This information can tell boards not only who the company's shareholders are, but also what issues are of concern to them and how they perceive the company's management and board.

Annual meeting data can be supplemented with feedback from Investor Relations roadshows, securities analysts' reports, media and press coverage, market research, benchmarking, investor surveys, peer and competitor analyses. These activities are routinely undertaken by management through the Investor Relations team, the Corporate Secretary, Corporate communications and other departments. Their findings should be shared regularly with directors and reviewed in preparation for the annual board evaluation. With this information in hand, the directors will have a better understanding of why ownership changes have occurred, what they signify, whether owners understand the company's business strategy, how owners have responded to specific board initiatives and whether company disclosures have adequately addressed owners' concerns.

In addition to shareholders and investors, the directors should be informed about any external constituencies that are affected either directly or indirectly by the board's activities and policies. Preparation for the board evaluation should take into account all aspects of the board's "job" and its core duties and responsibilities:

- Oversight of business strategy and long-term sustainability
- Capital structure and capital allocation
- Succession planning (both CEO and directors) and talent management
- Audit and accounting policy
- Executive and board compensation
- Risk oversight (including cybersecurity)
- Tone-at-the-top, corporate culture, ethics and reputation
- Policies on corporate governance, environmental practices and responsible social behavior (ESG)

A comprehensive look at the full scope of these responsibilities may lead to unanticipated demands on the board. If the company faces a crisis, the board will have to assume a leading role. In such cases the board must have the ability to quickly master unfamiliar issues and to understand the perspective of wide-ranging constituencies: communities serving and served by the company, governmental authorities, regulators, NGOs, special interest advocacy groups, traditional media and social media, politicians, international interests. There have been many recent examples of prominent companies facing banner-headline crises that have been unable to answer the key question: "Where was the board of directors?"

REPORTING AND DISCLOSURE

Armed with an understanding of shareholder concerns and expectations, the board and management can exercise their judgment in deciding what and how much the board evaluation report should say. They have full discretion, within basic legal disclosure guidelines, to explain how their decisions have been reached and why they create value and serve business goals. For example, if disclosure about executive compensation in the company's proxy statement contains elements that do not comply with proxy advisors' standards, a board evaluation report could provide additional perspective on the policy and business considerations that influenced the board's decision. This disclosure might in turn reduce the need for an extensive engagement campaign. Experience has shown that shareholders will generally support noncompliant pay practices that have a valid business purpose. The board evaluation report could be a vehicle to make the case for compensation and many other issues that rely on the board's business judgment.

The board evaluation report could also be particularly useful for companies to discuss ESG, non-financial risk factors, company culture and other topics where the board plays a central role. Although many companies publish mission statements and periodic reports on environmental practices, sustainability, health and safety, ethics and business conduct, a discussion of these topics in a board evaluation report would have the potential to integrate board policies with strategic business decisions and financial goals. Indeed, this type of holistic presentation is a goal of the integrated reporting <IR> movement that is gaining support from leading companies around the world.

A potential downside is that comprehensive board evaluation reports could stimulate additional questions from shareholders and increase demand for discussion and engagement. Transparency can increase trust, but it can also invite dialogue. Regardless of this risk, boards should recognize the value of addressing and potentially resolving issues before they surface publicly in the form of shareholder resolutions, dissident campaigns or an activist challenge. A well informed board that understands the perspective and expectations of owners will be able to take the initiative, deal preemptively with problems and avoid the risk of finding itself on the defensive in a public dispute. Conversely, shareholders who understand the board's thinking and business purpose will be less likely to seek engagement and more likely to cast their votes for the board at times when their support is most needed.

CONCLUSION

Thirty years of corporate governance reforms have concentrated attention on the critical role played by the directors of public companies. Shareholders recognize the board's importance but complain that they are asked to elect directors without being given sufficient information to make an informed decision. Today's board evaluations, mostly limited to compliance checks, peer comparisons and examination of internal processes, are private affairs, with results that may be meaningful but are rarely visible to constituents outside the boardroom.

Annual board evaluations have the potential to do much more. A robust evaluation process can inform directors, give them a voice and reassure a wide array of stakeholders that the board is representing their interests effectively. By providing early warning of constituents' concerns, the board evaluation process can also help the directors and management understand and deal with problems before they reach the stage of open confrontation.