Beyond Term Limits:
Using Performance Management to Guide Board Renewal
The debate over board renewal is moving into sharper focus. New public company disclosure requirements demand greater transparency on such things as term limits and other renewal mechanisms, and some large investors are sending the implicit message that companies must renew the board or they will seek to do it instead. The ICD agrees that the composition and renewal of the board are vital processes that demand rigour and analysis and are best undertaken by the board pro-actively. In this paper we seek to provide a framework for boards to build a renewal process that increases accountability and achieves the right mix of skills and experience to create long-term effectiveness.

To that end, we propose that boards across the for-profit, not-for-profit and Crown sectors build their renewal processes around the concept of performance management, including effective board evaluations set within a performance culture.

In other words, boards should review themselves the way they do their management teams. This means instituting regular and substantive evaluations of board composition and board member performance, and following through when necessary by having “tough conversations” with underperforming members or directors whose skills do not align with the organization’s strategy. This will help create a culture of accountability, and foster high performing boards.
Introduction

Beginning in 2015, most provinces in Canada will require greater transparency regarding gender diversity policies for non-venture issuer boards. One new rule stipulates that companies disclose their director term limits policy or details of other board renewal mechanisms they employ.

Proponents of term limits as a driver for board diversity point to the increasing age and tenure of directors on Canadian boards as evidence for the need for change. According to Spencer Stuart, the average age of non-executive directors in Canada in 2014 has risen to 63 (from 60 in 2009) and the average tenure to nine years (from eight in 2009).

The ICD has been one of the strongest advocates of gender diversity on Canada’s boards. We also strongly agree that ensuring directors continue to add value to their boards is crucial. However, we are concerned that the board renewal discussion in Canada has been placed in the context of manufacturing boards that meet externally motivated criteria or targets for membership.

In our submission to the CSA regarding their gender diversity disclosure rules, we took the position that board renewal should be focused on making boards better and not with a view to achieving a homogeneous formula:

> Board renewal is complex and requires time, thought and analysis and must always align with the company’s best interests while complementing its strategic direction. While the ICD is a proponent of the continuous upgrading of organizations’ boards, we do not think that renewal should come down simply to a matter of counting.¹

Pressures for change

The broad pressure for better board governance has come primarily from shareholders and other stakeholders insistent on improved organizational performance, transparency and diversity of director opinion and experience. The ICD shares these views. Further, we believe it is critical that, in Canada, we recognize the increasingly global environment in which our organizations compete and that, now more than ever, our boards leverage every opportunity to be the best they can be to help drive long-term effectiveness.

On the issue of term limits, the prevailing discussion in Canada has centered on their potential to foster greater gender diversity, whereas in other countries the issue of director tenure has been considered in the context of director independence from management. In France, for example, a director that serves on a board for more than 12 years is no longer considered to be independent. In the UK, the board must publicly state why it believes a director serving beyond nine years is still considered to be independent.

The investor community has also been applying pressure on public company boards to adopt board renewal strategies. Activist shareholders, including certain hedge funds, have been vocal in demanding that the companies in which they are invested are serious about board renewal - ostensibly with a view to adding more sector experience or leadership to their boards. Some institutional investors in Canada have also expressed a desire to pursue greater proxy access – that is, to have the right to nominate a percentage of board directors once a certain share-holding threshold has been achieved. The message to boards from the large investor community is to renew or they will seek to do it instead.

Proxy advisory firms such as ISS have also begun to look at director tenure in the context of independence. For example, in their Quickscore 3.0 product, ISS considers length of tenure in its opinion of directors’ independence. These firms have grown into key sources of information, analysis and guidance on proxy votes for institutional investors and, therefore, are considered by their clients as arbiters of corporate governance practices.

Incorporating performance management into board renewal

Whether due to regulatory changes such as mandated diversity or independence disclosures or due to increased focus by shareholder groups, boards are feeling external pressure to review their renewal practices. While external pressure can sometimes bring about positive change, on the question of their future composition, it is vital that boards build a framework unique to their forthcoming challenges and that they apply a great deal of thought and analysis if they seek to maximize their effectiveness over the long term.

Performance management systems, characterized by objective-setting and supervisor evaluations are commonly applied to executives and other employees and are an effective way of ensuring quality throughout organizations and of making key staffing decisions. Indeed, boards regularly use performance management in their evaluations of CEOs. Importing this concept to the board is a useful way of building a framework for renewal.

By incorporating performance management tools, including board composition reviews and board evaluations with mechanisms such as term limits, boards can identify areas for development and/or underperformance and recognise needed skills and competencies around the boardroom table. Framed within a performance culture that expects and enforces accountability with a tone set by the chair, an effective framework for board renewal can emerge.

BOARD COMPOSITION REVIEW

A crucial first element of any performance management system is a thorough and regular review of staffing and skills needs of the organization. At the board level, this means a review of who sits on the board and the skill-sets they bring to the table. Many boards employ skills matrices for this purpose to ensure that the competencies needed to carry out its mandate
and advance the organization exist at the board. Core skills could include CEO or senior executive experience, audit experience or relevant industry knowledge.

Skills that are being added to matrices also include risk management, IT and social media experience and, while not traditionally an element of a skills matrix, diversity – of opinion, gender and background – is increasingly being viewed as a key component of board composition.

Behavioural competencies are also an important component of effective board composition. As detailed in a Korn Ferry International/Patrick O’Callaghan and Associates survey, Canadian directors highlight integrity and trust, courage, ethics and values, and strategic agility as examples of the personal character qualities critical to a successful board.

Those skills and qualities the board determines it needs should be a primary input into its performance management and succession planning process, including the recruitment of new and/or replacement directors.

BOARD EVALUATIONS
Understanding actual and needed director skills is an important first step but the most vital component of board performance management is an assessment of the strengths and weaknesses of the current board and directors. Most public corporations in Canada already undertake some form of annual or rolling self-evaluation – whether full board, director self-evaluation or peer-to-peer evaluation - and we would argue that one or a combination of these practices would benefit organizations across all sectors.

- Full board evaluations
Full board evaluations require directors to focus on the functioning of the board as a whole, rather than on individual directors. Questions may, for example, focus on the board’s understanding of management strategy, the composition of the board and the mix of skills around the table, the structure and organization of board meetings and committee meetings and other issues core to the execution of the board’s mandate.

- Individual director evaluations
Director self-evaluations require individual directors to respond to a series of questions regarding their own board performance, including how their skills contribute to the effectiveness of the board, their commitment to the board, their preparedness for board meetings and other responsibilities.

Peer-to-peer evaluations require individual directors to respond confidentially to questions regarding their colleagues’ board performance and commitment, including how their fellow directors’ skills contribute to the board’s effectiveness.
EVALUATION METHOD
The most basic approach to board evaluation is the written questionnaire where directors respond to a series of questions regarding either the functioning of the full board, their own performance or the performance of their colleagues.

While questionnaires can provide a good baseline of information and offer some insight into issues for further discussion, they can be too simplistic to capture nuance and drive real change.

A slight alternative is the survey, which offers directors an opportunity to expand on their responses through open-ended questions and can often lead to more thoughtful views on the direction of the board.

Interviews conducted by the chair of the board or the chair of the governance committee can also elicit greater depth of responses. This practice provides directors an opportunity to expand on certain crucial issues (e.g. the mix of skills at the board) and bring areas for improvement into sharper focus.

Independent third-party interview evaluations performed by board consultants can also produce meaningful responses and provide an added layer of confidentiality for directors.

Finally, some boards opt for a facilitated board discussion. While the relative anonymity provided by questionnaires, surveys and one-on-one interviews is no longer available in a group meeting, the iterative nature of these meetings can produce fruitful discussion regarding the direction of the board and the need for new skills in the boardroom.

Ultimately, the goal of the evaluation process is for the board to achieve greater insight from its individual directors regarding their perceptions of the strengths of the group and its members and to identify areas for improvement. While questionnaires and surveys can provide a baseline, we believe internal and/or independent, external interviews provide the greatest opportunities to gain quality feedback.

TERM LIMITS
Many boards in Canada feel that term limits serve a purpose, with 56% of Canadian Spencer Stuart Board Index (CSSBI) companies reporting they employ voluntary term or age limits. According to a recent Korn Ferry International/Patrick O’Callaghan and Associates survey, term limits for Canadian public companies surveyed ranged between seven and 20 years with 53% of those companies having a 15 year term limit.

The ICD agrees that voluntary term limits have their place and can act as a backstop against excessive tenure lengths, which can lead to the perception of eroding independence. They may also provide some predictability around director position openings. However, mandatory limits could also be counter-productive to the good governance of Canadian organizations.

Term limits are a blunt tool and, without flexibility, they eliminate effective as well as non-effective directors. For this reason, we believe that boards must retain discretion to preserve vital institutional memory of high performing and contributing members.
On some boards, we have also observed that term limits can have the effect of replacing “tough conversations” with directors who no longer add value to the organization, therefore obviating the accountability inherent in identifying and addressing weaknesses. Boards should not “wait out” a poor director’s term and, instead, should be prepared to ask them to resign before their terms are finished.

**PERFORMANCE CULTURE**

Ultimately, the tools described above are only of value if they are set within a culture that values – and enforces – high performance from individual directors and the board as a whole. That is to say, the data provided through these mechanisms is acted upon. Performance cultures are characterized by the high value they place on accountability and are continually striving to meet their objectives.

A board operating within such a culture will act on the results of evaluations. This can and should mean that processes that are not working well will be changed and, sometimes, directors who are not adding value or who do not have skills aligned to board and organizational strategies will be asked to resign.

Occasionally, tools such as skills matrices and evaluations will reveal a gap in terms of competencies at the board vis-à-vis organizational strategy but no obvious deficiencies in terms of individual director performance. Boards seeking to maximize their effectiveness must reconcile this by being willing to move out directors whose input may still be valuable but whose skills and experience do not align with where the organization is moving.

**Role of the Chair**

At the board, performance cultures are established primarily by the Chair who must take the lead in the director evaluation process and must set a tone of accountability. If, after building a skills matrix and completing board evaluations, weaknesses at the board are apparent, it falls to the chair to address these with directors who are deemed by their colleagues to no longer be adding value.

A board that is subject to rigorous evaluation and that understands from the Chair that it is accountable has every incentive to be effective. Stated simply, if the Chair informs the director from the start that he or she may be involved in a tough conversation, there is usually no need to have one.

Just as the board should be subject to a performance management-based renewal process, so too should the Chair be evaluated and held accountable. This should be done through a well-understood process managed, typically, by the chair of the Governance Committee and that takes into account the Chair’s unique role in setting the tone and fostering a performance culture.
Conclusion

New reporting requirements in Canada demand that boards of non-venture issuers think more deeply about their renewal process, but organizations across all sectors are equally confronted with the challenges of building boards that are effective in the long-term.

Modern boards are increasingly expected to take on complex organizational oversight and governance roles. We would argue then, that renewing them should also be a process involving a great deal of thought and analysis. While term limits can be a supporting mechanism, relying solely on them to renew the board is insufficient and may be counter-productive to good corporate governance. Rather, establishing renewal around the concept of performance management within a culture that demands accountability of directors and maintains a firm view on the future needs of the board provides a more effective framework for renewal.

ABOUT THE INSTITUTE OF CORPORATE DIRECTORS

The Institute of Corporate Directors (ICD) is the definitive ‘go-to’ resource and voice for Canada’s directors and boards in the for-profit, not-for-profit and Crown sectors. As the national community for directors, the ICD is a not-for-profit, member-based association with more than 9,000 members and a network of 11 chapters across Canada. Representing the interests of directors, the ICD fosters the sharing of knowledge and wisdom through education, professional development programs and services, and thought leadership and advocacy to achieve the highest standard of directorship. For more information, please visit: www.icd.ca.

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