
Renewing the board

By Donald Nordberg

"There is a crisis looming in Boardrooms from coast to coast, one that invokes the simple economic principle of supply and demand."

"Increased responsibilities and a shortage of qualified candidates will likely result in substantial increases in compensation for outside directors."

"Board directors for US corporations have been facing an increasing number of demands. At the same time, the pool of available candidates to fill such positions has been shrinking."

"Just when Boards need them most, independent, qualified directors are becoming scarce."

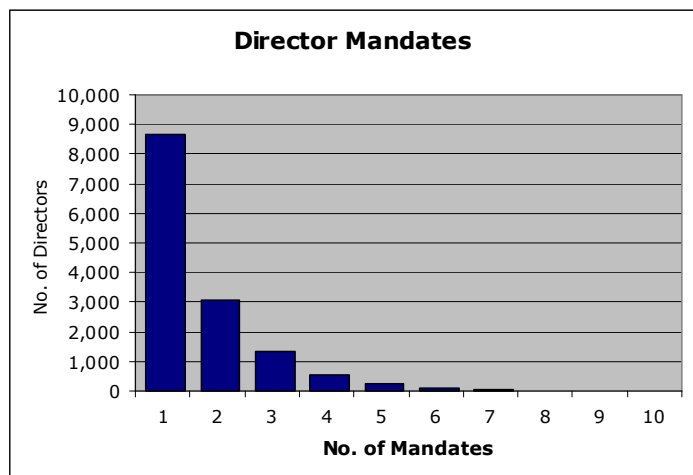
These commentaries – drawn from thousands since the corporate governance crisis rocked America in 2002 – point to a serious issue, one that will not simply go away. Is the situation really so alarming? Or are these commentators being alarmist?

Since the Sarbanes-Oxley Act and adoption of new listing rules at the exchanges, would-be outside directors of listed companies face a higher threshold of skills. They must not only be independently minded. They must now meet regulatory criteria for independence, too. They must work longer hours. In the current climate, any board facing the task of recruiting new directors must be worried about three questions:

- Is the pool of talent big enough?
- Will the new rules frighten would-be directors away?
- And will we be able to find the necessary expertise?

Fears about the size of the pool have been based largely on conjecture or interviews with board chairmen and directors. The executive search firm Korn/Ferry, for example, conducted a much-quoted survey of several hundred directors in Canada¹. More than 60 percent believed they faced a shortage of qualified candidates. These views are, of course, impressionistic and based – as the survey itself shows – partly on their belief that selecting board members is now a much more serious task. Fully 91 percent on the respondents said they were themselves being more vigilant about assessing approaches they receive to join new boards. And anecdotal evidence suggests the situation is not much different in the US.

Source: BoardEx



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I don't suggest that the task isn't difficult. Or that the changes in US corporate governance hasn't made the process of identifying directors a task that requires a more rigorous analysis than the Friends-of-Bill approach in the past. But the answer to at least the first of these questions is that the pool of qualified directors is actually a lot larger than the scare stories suggest.

Director-mandates

Data from BoardEx, an international online board and director analysis system, point to a large number of individuals already serving as corporate directors who may have potential to take on more board mandates. BoardEx profiles 14,000 individuals serving on the boards of more than 4,000 listed companies in the United States. A large majority of the individuals – 8,655, or 61.6 percent of the total – serve on only one board. These are individuals, in the main, whose own companies regard them as qualified to be directors, but they don't share their knowledge and expertise with any other company.

Just because someone is a director, though, doesn't automatically mean he has capacity to serve on more boards. Most individuals with only one or two board mandates are full-time employees as well – chief executives or financial directors of their companies – and they face serious demands on their time. But does that mean they are really *too busy*?

'Busy' directors

One of the seminal pieces of academic research in corporate governance showed that poor governance tended to go hand-in-hand with poor performance. Moreover, it identified a strong correlation of poor performance and directors were too busy serving on other boardsⁱⁱ. "Busy" directors were those executives with three director-mandates outside the company where they were employed, or six for those not in full-time employment. By this definition, a few directors are very busy, indeed. Two of the 14,000 in the BoardEx data claim 19 director-mandates each. But those are the great exceptions. But most have capacity.

This notion helped inform guidance from the National Association of Corporate Directors, which warns "employed" directors against taking on more than four mandates in total, and three if it's the CEOs or another senior executive on the board of the company where they are employed. The Council of Institutional Investors – looking after shareholder interests – takes a more conservative line. It recently scaled back its guidance for employed directors from three mandates in total to two, and also asked CEOs who weren't in the top half of their peer groups to decline outside mandatesⁱⁱⁱ. Using either model suggests there is – at least theoretically – significant unused capacity for new directors. The table

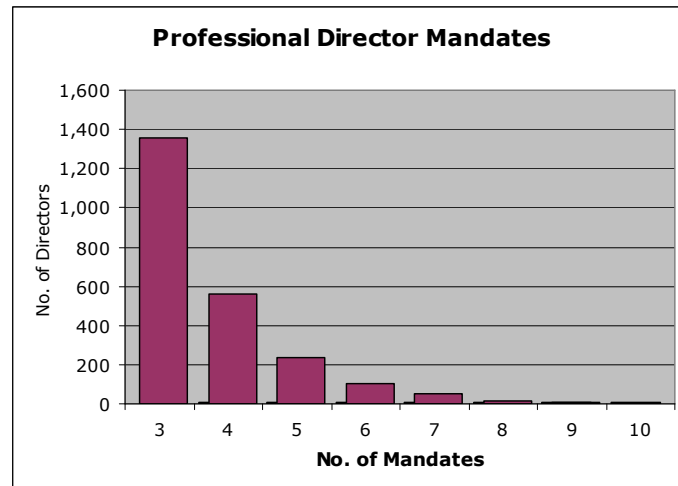
"Capacity for Additional Mandates" summarizes the impact of that advice.

| Capacity for Additional Mandates | | |
|------------------------------------|---------------------------------------------------|--------------------------------------------------|
| No. directors with 1 or 2 mandates | Estimated additional capacity under NACD guidance | Estimated additional capacity under CII guidance |
| 11,709 | 25,748 | 14,039 |

Changes in corporate governance practice have increased workload of directors, to be sure. Spencer Stuart's annual Board Index released in November 2004 shows the number of board meetings of S&P 500 companies is now eight a year, having crept up since the collapses of Enron and WorldCom and the increased regulatory pressure^{iv}. Committee work grew, too. Audit committees of the S&P 500 met on average 8.7 times a year in 2004, up from 7.3 in 2003 and only five times in 2002. Those factors argue for taking a more conservative approach than the CII one. Even so, there would seem to be scope from the pool of these serving "executive-directors" to accommodate well over 10,000 additional mandates.

'Professional' directors

There is already a body of individuals we might call "professional" directors. They're often retired CEOs or other corporate officers who concentrate now on serving as outside directors. Eugene H. Fram, the J. Warren McClure Professor of Marketing at the Rochester Institute of Technology, has identified these people as one of three groups of people who represent an underutilized resource for directorship^v. Others are senior managers approaching retirement and mid-career executives looking to expand their skills. The latter two categories include many who haven't served on boards of listed companies and might fall down at the first hurdle. But the first group represents a pool we can estimate.



The BoardEx data include names of individuals and the boards of listed companies they serve, the mandates they have held in the past, as well as background on their other interests. Those with three or four mandates – the prime candidates for Fram's first and second category of professional directors – total 1,919. This, too, suggests further capacity is already available.

Conclusion

The BoardEx data give some comfort that there is not an impending crisis in the number of people to serve as corporate directors. They show that a large proportion of current directors have at least a theoretical capacity to take on additional mandates. Many, I'm sure, will choose not to – too engaged in operating their own businesses. Moreover, the burdens directors face have clearly increased, as suggested in CII's tightened guidelines. But most of the pressure imposed by Sarbanes-Oxley – things like certification of results – fall mainly on executive directors: those directors also serving as full-time employees of the company. Will we be able to find the right expertise? That's a question nominations committees and their advisers will still have to answer.

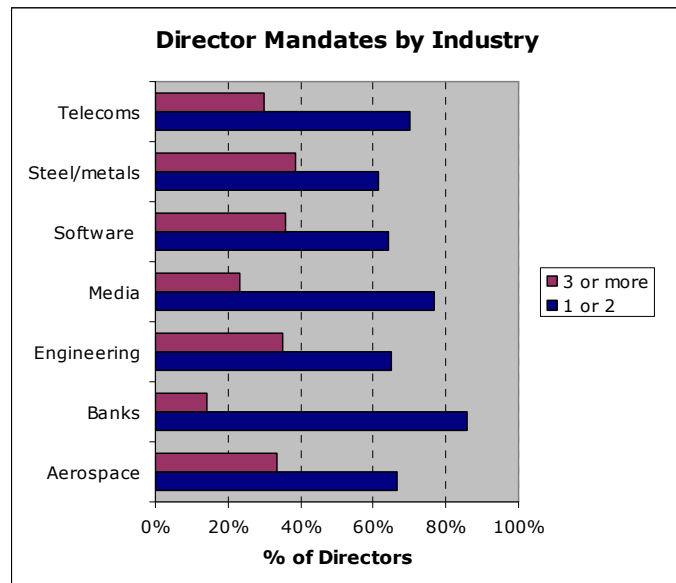
Guidelines for identifying directors

1. Look for candidates already serving on a board in an adjacent industry or those who have been directors in your industry but don't currently serve on a competitor's board.
 2. Consider academics, lawyers, accountants or other professionals who may have served on boards before: they might be set on a new career as professional directors.
 3. Senior managers at large companies who are not yet directors may well bring valuable insights to smaller firms and relish the opportunity to expand their experience with a board mandate.
 4. Experience on not-for-profit boards might be useful, especially where reputational risk is high and the board would benefit from input on ethics. But watch out for interests that may conflict with achieving the greatest value.
 5. Investigate backgrounds of candidates – schools, interests, hobbies. It will help ensure a cultural fit to your board.
 6. Watch out for real and potential conflicts of interest that may arise from a candidate's network of connections – not just from other boards, but from universities, clubs and previous employers.
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Industry comparison

It is difficult to ascertain the scope from the data how much capacity there is for the specific skill of financial expertise now demanded for audit committees by listing requirements and Sarbanes-Oxley. But we can see industry expertise. The BoardEx data show that three-quarters of the directors of US banks, for example, have no more than one outside mandate and many will have at least some degree of financial expertise.

The sectors most heavily dependent on "professional" directors – those with three or more directorships – are steel and software. But even there, the percentage of lightly committed directors is more than 60 percent.



ⁱ See

<http://www.kornferry.com/Library/ViewGallery.asp?CID=551&LanguageID=1&RegionID=23>

ⁱⁱ "Corporate governance, chief executive officer compensation, and firm performance," John E. Core, Robert W. Holthausen*, David F. Larcker, *Journal of Financial Economics* (1999), Vol. 51 pp 371-406.

ⁱⁱⁱ See <http://www.edgevantage.co.uk/categories/article.asp?i=2282>

^{iv} See <http://www.edgevantage.co.uk/categories/article.asp?i=2254>

^v "Are Professional Board Directors the Answer?" Eugene H. Fram, *MIT Sloan Management Review*, Winter 2005, Vol. 46, No. 2, pp. 75-77.