Board trends for 2006: It's back to the future

After digesting Sarbanes-Oxley, boards prepare to resume their strategic role.

AN INTERVIEW WITH THEODORE L. DYSART

As we enter a new year and a new quarter, it's the time to ask what issues of corporate governance boards and directors can expect to face in the coming year. Ted Dysart, who leads Heidrick & Struggles' Board Practice for the Americas, identifies the trends in board responsibilities, composition, and challenges likely to dominate in 2006 and beyond.

As we look back on 2005 and earlier years, what has been the most significant long-term trend in board governance?

For the past three years, boards have been preoccupied with issues of compliance, largely stemming from Sarbanes-Oxley (SOX). Those concerns were driven not only by the rigorous — and some would say onerous — requirements of the law, but also by a genuine desire to avoid the improprieties that occurred in the highly publicized corporate scandals that marked the early years of this decade. Directors didn't want to appear to be asleep at the switch and, more important, they certainly didn't want their integrity and their reputations for excellence inadvertently compromised by the actions of management.

Now, however, boards have begun to be less preoccupied with SOX and Section 404 compliance. Instead, they are returning to their role as a sounding board for management — asking themselves how they can best work as strategic advisers to CEOs and their management teams. Once again, they are spending considerable time and energy thinking about the business, bringing their expertise to bear on issues of growth, and seeking to provide their companies with competitive advantage. This transition really began in 2005 but is likely to accelerate in 2006.

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— Theodore Dysart

What accounts for the change?

Three factors: a strong economy, new competitive pressures, and a growing mastery of SOX on the part of boards and the companies they oversee.

First, according to most observers, the economy is strong and getting stronger, with continued growth in productivity, consumer spending, and new job creation. At the same time, many companies are benefiting from growth in profits, strong internal cash flows, low interest rates, and increases in demand that result from sustained economic growth. In this environment, many directors see tremendous opportunities for growing the business. Directors are excited by the prospects, and they are deeply engaged in providing management with the guidance that can help companies capitalize on those opportunities.

Second, new competitive pressures are also drawing directors back into their traditional role as strategic advisers. Perhaps the greatest pressure is coming from the rise of China, which is seen both as a threat and as an opportunity. How do you take advantage of the opportunities for the offshoring of manufacturing and services that China offers? How do you operate effectively in what is likely to become one of the largest markets in the

world? How do you make your goods or services competitive with those that already benefit from the cost advantages of China? Answering those questions will increasingly require the kind of bold management initiatives that can be undertaken only in consultation with the board.

Third, boards have now thoroughly digested Sarbanes-Oxley. They've been through the eight-hour audit committee meetings; they've gotten past implementation; they've gotten their 404 certifications. Now, as they move into subsequent cycles of auditing and reporting under the law, they are confident that they have procedures and processes firmly in place to handle it. As a result, they can now get back to the really challenging strategic questions — how to transform and grow the business.

What issues are particular board committees likely to face in 2006?

After the trauma of the past several years, audit committees have regained their footing and now feel confident about their ability to meet tougher standards of compliance and to fulfill their fiduciary responsibilities. Similarly, nominating and governance committees have emerged stronger and more confident from the recent upheavals. They have taken the lead in the far more rigorous self-evaluations of performance that boards now undergo, and they have worked hard to improve them. As a result of SOX, the chairs of nominating committees are also enthusiastically taking charge of the recruiting process for new directors and committee members, taking a proactive role instead of rubber-stamping managements' nominees.

The one dark cloud on the horizon is heading toward compensation committees. Shareholders and investors are concerned about the growing size of executive pay and severance packages, and they want to see compensation more clearly tied to executive performance. Legislators are also taking up the issue of compensation.

In November 2005, the Protection Against Executive Compensation Abuse Act was introduced in the House of Representatives, which was scheduled to take up the bill at the beginning of this year. Among other things, the bill would require a company's annual report and proxy statement to provide a comprehensive statement of its compensation plan for principal executive officers. Public companies would also have to obtain shareholder approval for the company's plan and would have to make public the company's policy for recapturing any form of compensation that subsequent financial results show are unjustified. Whether this bill passes or not, it certainly signals a heightened interest in the issue of executive compensation. And whether or not Congress passes any legislation, the Securities and Exchange Commission will likely take up the issue under its new chairman, Christopher Cox.

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As a result, compensation committees will likely be under great pressure to forge strong links between pay and performance. They will also face the dilemma of controlling executive compensation while keeping the company competitive in an escalating market for top executive talent.

From an individual director perspective, the number one concern for directors always has been, and likely always will be, risk management. No matter how much diligence and oversight directors exercise, they always worry that they might have overlooked some issue or problem that could put the company in jeopardy. They worry also that the company could be overwhelmed by some utterly unforeseeable circumstances — what Defense Secretary Donald Rumsfeld memorably called "unknown unknowns," the things we don't know that we don't know.

What formerly hot-button issues will recede in importance?

Governance itself. Not that good governance will cease to be a prime concern of boards, but the almost obsessive worry about precisely what constitutes good governance will fade. Prior to the corporate scandals and the legislative reaction to them, boards lacked a clear roadmap for how to behave. They were often unsure about how to fulfill their oversight responsibilities and how intrusive they should be with management.

Over the past three years, they have devoted a lot of energy to addressing those issues, especially the delicate balance between the board and management. Directors are far more willing to probe management, and management expects it. And now that boards are comfortable with the redrawing of boundaries that has taken place, they will be able to spend less time defining good governance and more time providing it.

How is the rise of China and other Asian powerhouses likely to affect the composition of boards?

Many companies will once again push to globalize their boards. A similar push occurred in the early 1990s, when many companies added directors from around the world. However, the long distances such directors had to travel often made attendance at board meetings difficult and limited their participation in board activities. This time around, many companies are seeking U.S.-based directors who have extensive experience working abroad.

Others are still interested to add directors who live abroad. In fact, at the request of a number of Fortune 500 companies, we are currently recruiting directors living in China. As these trends play out, the debate is likely to heat up about whether it is preferable to have a foreign national on the board as opposed to an American with international experience. Interestingly, about 90 percent of Europe's largest companies have one or more directors from outside their home country, while the

percentage for America's largest companies is far lower.

In what other ways is board composition likely to change?

There will be fewer CEOs, for two reasons. First, many boards — again in the wake of scandals and SOX — now insist that their chief executives concentrate fully on their day jobs. Formerly, many CEOs served on numerous boards and turned day-to-day operations over to a president or chief operating officer. Increasingly, however, companies restrict the number of outside boards on which their CEO can serve and, in some cases, prohibit it altogether.

Second, with the new emphasis on strategy, many companies are building boards that include not only CEO generalists but also directors who have risen through specific functional areas in which the company must excel in order to compete effectively — sales and marketing, global operations, manufacturing, and others. They expect these teams, comprising the different competencies important to the company, to provide additional strategic advantage. Increasingly, we are being asked to undertake these more highly specialized and targeted director searches.

One thing that won't change, however, is the demand for directors with a background in finance. They have always been sought after as directors, and SOX has only increased that demand. As a result, CFOs will remain highly desirable as directors.

With fewer CEOs on boards and with more highly specialized candidates in increasing demand, won't the talent pool of qualified directors shrink?

The talent pool has actually expanded as a result of a widespread redefinition of what constitutes a qualified candidate. Instead of focusing almost exclusively on CEOs as candidates for the board, companies are increasingly tapping division presidents and other executives who have experience running large operations. For example, we recently helped place on the board of a Fortune 1000 company a division president who is responsible for a $10 billion operation and has extensive global experience.

The trend toward building teams of specialists from different functional areas has also expanded the talent pool. Previously, companies widened their searches in a desire to achieve more racial and gender diversity on their boards. Now they are widening their searches more generally as they further redefine the qualifications for board membership.

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What is the outlook for diversity in the composition of boards?

Interestingly, the general redefinition of director qualifications also expands the talent pool of diversity candidates, who may not have risen to chief executive but excel in a critical functional area. In both the expansion of boards to accommodate diversity and their expansion to include more non-CEOs, the results have been almost universally a win-win for the companies as well as the candidates.

Will it therefore be easier for boards to fill vacancies?

Not necessarily. Although the pool of qualified candidates is larger, many candidates are far more reluctant to serve. More than ever before, candidates are exercising diligence about the companies recruiting them. They're calling the CFO, doing extensive research, and tapping into their network of contacts to get the lowdown on the company. Again, as a result of scandals and SOX, they want to mitigate as much as possible the risk of associating themselves with a disaster or incurring personal liability.

Candidates are also far more critical and objective about their ability to add value, particularly in complex organizations such as conglomerates, or industries like financial services and insurance. The overwhelming reason why candidates decline to serve, however, remains a lack of time. Given their already enormous responsibilities, many qualified and desirable director candidates feel that they would be unable to devote adequate attention to the job.

You've painted a generally upbeat picture. Is this a good time to be a director?

Most of the directors I talk to are excited. Not to overstate it, but being a director is once again going to be fun. As the climate of fear and uncertainty in which boards have been operating for the past several years begins to recede, directors will find themselves once again engaged in the kinds of issues that first attracted them to business careers — strategy, innovation, and competition.

Historically, boards snapped into action only in times of crisis. Today they are taking far more seriously their roles as mentors and monitors. They are taking care to establish the right tone at the top of the company. They are forging healthier and more productive relationships with management. The result will be a win for everyone — a stronger business and more long-term value for shareholders. ■

The author can be contacted at tdysart@heidrick.com or by telephone at 312-496-1345.