

20 Questions Directors Should Ask about **Building and Sustaining an Effective Board**

Elizabeth Watson, QC



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Preface

The Risk Oversight and Governance Board of the Chartered Professional Accountants of Canada (CPA Canada) has prepared this *20 Questions* briefing to assist our members in understanding how an effective board of directors is constituted and maintained. This may sound like familiar territory, but those who have served will know that often boards are so busy trying to fulfill their mandates that there is little time to step back and reflect on what is working, what may not be working and why (or why not). Just as the complexity of doing business in the 21st century has increased over previous decades, so too have the requirements and demands made of boards of directors and their members—and the potential liabilities.

20 Questions Directors Should Ask about Building and Sustaining an Effective Board has been informed by some of the best current thinking on such issues as: the recruitment and retention of board members, board renewal, the setting of term limits, the meaning of “diversity” and how to achieve it, directorial independence, and many others.

Whether you are currently serving on a board, considering accepting a directorship or interested in learning more about what such a commitment would entail, we are confident that the information presented in the following pages will offer much food for thought, and perhaps illuminate some challenge you are facing.

The Risk Oversight and Governance Board is grateful for the invaluable contribution of author Elizabeth Watson, QC of Watson Advisors Inc., whose insight and wisdom course through this publication. We thank as well our fellow board members and the staff of CPA Canada for shepherding this document through to completion.

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Introduction

Over the last decade, there have been significant changes to corporate governance practice, encouraged in large part by legislation, regulatory requirements and the building of consensus around best practices. Despite these developments, there are still many high-profile examples of poor governance, poor corporate performance and corporate failure. Such examples have led to renewed recognition that the most significant contributors to a high-performing board are the quality and experience of individuals serving on that board and the way in which those individuals work together. For this reason, CPA Canada determined that it would be useful to revisit its guidance in the area of board composition and succession. Effective board functioning will be dealt with in a forthcoming CPA Canada publication.

20 Questions Directors Should Ask about Building and Sustaining an Effective Board provides insight and guidance on the various elements involved in creating a high-performing board—including board structure, ideal director characteristics, board leadership, planning for director recruitment and sustaining the competency of directors through orientation and ongoing education. The 20 questions are structured to guide readers through the various stages of a board's evolution, from creation through to renewal. As such, the questions are grouped under the following sub-headings:

- **Establishing** the Board (Structural Considerations)
- **Sustaining** the Board (Skills, Leadership and Culture)
- **Renewing** the Board (Succession Planning)

This *20 Questions* publication is intended to provide useful information for directors, shareholders and others interested in building and sustaining a high-performing board. The questions and suggestions for recommended practice are set primarily within the context of publicly listed companies, but the concepts and principles may be extrapolated for other circumstances as well.

The structure and composition of a board are important elements that contribute to a board's effectiveness, and a well-composed board is a crucial prerequisite for effective governance. Equally important, though, when assessing a board's level of performance is *how* a board performs its work. This includes such elements as having clear roles and responsibilities, effective decision-making processes in place and a constructive board-CEO relationship. These elements are not specifically addressed in this publication, but they are essential in order for a great group of directors to perform well.

Establishing the Board (Structural Considerations)

This section contains commentary on some of the essential elements to consider when establishing a board: the board's size and composition (including requirements for director independence) and the director election process, including the role of shareholders.

1. What is the optimal size of a board?

Legal requirements in most jurisdictions specify a minimum number of board members (usually three), but typically there is no maximum limit. There is no one “perfectly sized” board, and in fact it is considered leading practice to determine proactively the optimal size of an organization's board of directors based on that organization's unique circumstances.¹ While research suggests that a group of five or seven is an optimal size for decision-making, various other considerations come into play in a board setting.

A board must be large enough to ensure that there are sufficient members to manage the board's workload (including committee work) and that, collectively, the board members have the required skills to govern. These considerations must be balanced, however, against the need to ensure that the board is small enough to enable interactive discussion (i.e. conversational turn-taking) and engagement by all directors. Large boards can prove cumbersome and can make the meaningful exchange of ideas, information and creative thinking difficult, if not impossible. They can also weaken individual directors' accountability.

¹ Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendation*.

Factors to consider when determining the optimal board size include the:

- company's size, scope and complexity
- mix of skills and experience required around the board table to address the board's responsibilities
- number of committees and the need for enough independent directors to populate those committees (see Questions 2 and 9)
- relative cost of a larger board vs. a smaller board, and
- need for meaningful interaction which leads to robust discussion and debate.

In 2011, the smallest board in Canada had three directors and the largest had 21.² In both Canada and the United States, larger, more complex companies typically have larger boards (e.g. 13 or more directors) than smaller companies. However, nine is the average board size for listed companies in both countries.³

2. What are the independence requirements for directors?

Corporate governance guidelines adopted by the Canadian Securities Administrators,⁴ and applicable to most public companies in Canada, provide that a majority of directors on any board should be “independent” (as defined below). In addition, stock exchange rules in both Canada (TMX⁵) and the US (NYSE and NASDAQ)⁶ require that the boards of listed companies should be constituted with a majority of independent or ‘unrelated’ directors.

The precise meaning of “independence” varies across jurisdictions and readers should refer to the applicable definition in the specific rules that govern them. In general however, a director is considered “independent” if they have no direct or indirect material relationship with the company which could, in the view of the board, reasonably interfere with the exercise of that director's independent judgment. The Canadian governance guidelines⁷ also enumerate specific kinds of relationships that preclude

2 Korn Ferry, O'Callaghan, *Corporate Board Performance and Director Compensation in Canada: A Review of 2012*, p. 35.

3 *Ibid.*

4 CSA National Policy 58-201—*Corporate Governance Guidelines* (NP 58-201), National Instrument 58-101—*Disclosure of Corporate Governance Practices* (NI 58-101) and Multilateral Instrument 52-110—*Audit Committees* (MI 52-110)

5 TMX Company Manual, s.473

6 NYSE Listed Company Manual Section 303A.01 and Nasdaq Equity Rule 5605(b)(1)

7 Multilateral Instrument 52-110, Section 1.4

an individual from being considered “independent,” including: former employees or officers (within the last three years); immediate family members of former or current officers; and anyone who has received more than a specified amount of compensation from the corporation (with the exception of directors’ fees) in the previous year.

As part of their disclosure obligations, boards should communicate their approach to directors’ independence, as well as the independence status of any director nominees. Some boards require directors to complete an independence questionnaire to ensure that all regulatory aspects of independence are explored and then disclosed as appropriate.

While the regulatory definition of independence is important, the pursuit of effective governance arguably requires the consideration of a much broader concept of independence—whereby each director exercises “independence of thought” and makes decisions in the best interests of the company, without being “captured” by management or inappropriately influenced by other directors. For example, in a school, club or business setting the power dynamic in the boardroom may be influenced by relationships that exist between or among directors, and between a director and a member of management. This may make other participants unwilling to challenge or advance their own views. Some also argue that overly generous directors’ pay and long board tenure may inhibit a director’s real independence. The UK Governance Code appears to presume that a director who has served for more than nine years is no longer independent, requiring the board to explain why that person is still considered independent “in character and judgment.”⁸

8 The UK Corporate Governance Code (2012), Section B.1.1.

B.1.1. The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director’s judgment. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- *has been an employee of the company or group within the last five years;*
- *has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;*
- *has received or receives additional remuneration from the company apart from a director’s fee, participates in the company’s share option or a performance-related pay scheme, or is a member of the company’s pension scheme;*
- *has close family ties with any of the company’s advisers, directors or senior employees;*
- *holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;*
- *represents a significant shareholder; or*
- *has served on the board for more than nine years from the date of their first election.*

One area of potential compromise to independence that has drawn attention is interlocking board memberships. The Canadian Coalition for Good Governance suggests that boards should have policies in place that limit interlocking relationships of all kinds, including:

- **board interlocks**, where two directors of Company A sit on the board of Company B, and
- **committee interlocks**, where two directors sit together on another board, and are also members of the same board committee.

According to the Canadian Coalition for Good Governance, “[too] many interlocks suggests a degree of inter-related interests that might be detrimental to director independence.”⁹

On the opposite side of the independence argument, there is a concern that an undue emphasis on recruiting independent directors may result in too many directors who lack sufficient knowledge about the company and industry to be able to add value in boardroom discussions. It is recognized that many directors who would not be considered independent for regulatory purposes are fully independently minded and speak their mind no matter what other relationships exist.

In summary, while governance guidelines on independence may be important for compliance purposes, the real key to building an effective board is to ensure that directors are indeed able to exercise “independence of mind” in the boardroom on all issues with a view to the best interests of the company.

3. What role do shareholders play in the selection of directors?

Although it is generally a board’s nominating committee that proposes director candidates for election, it is the company’s shareholders who elect directors. Shareholders have been increasingly concerned about ensuring that their right to elect directors is meaningful, and boards must be aware of the rise of shareholder activism in this area and have a plan to address the issue, if it arises.

As a result of shareholder advocacy, the TSX amended its Company Manual in late 2012¹⁰ to require all TSX-listed issuers to: elect directors annually; allow shareholders to vote for each director (rather than for a

9 Canadian Coalition for Good Governance, *Building High Performance Boards*, March 2010, Guideline 2.

10 Effective December 31, 2012

slate of proposed directors); disclose publicly the voting results for each director; and disclose, in its management information circular, whether or not the issuer has adopted a majority voting policy for directors at uncontested meetings.¹¹ In February 2014,¹² the TSX adopted further amendments to the Company Manual to require that each director be elected by a majority of votes cast with respect to his or her election, other than a contested meeting. A nominee who is not elected by at least a majority of votes must submit their resignation and the board must accept this resignation, if no exceptional circumstances exist.

The 2012 proxy battle at Canadian Pacific Railway is a dramatic illustration of the extent of shareholder activism, with the ultimate outcome being a majority of new directors elected to the board and subsequent replacement of the CEO.

A recent study by Fasken Martineau¹³ revealed that there were 101 proxy contests in Canada from January 1, 2008 to December 31, 2012, which represents an 84 per cent increase from the previous five-year period. Comparing the same five-year periods, there was a 98 per cent increase in the number of proxy contests that focused on change in the boardroom. Notably, in 54 per cent of all board-related contests, dissidents were successful in their public campaign for change.

In the United States, recent amendments to SEC Rule 14a-8 require companies, in certain circumstances, to allow shareholders to submit and vote on “proxy access proposals”—that is, proposals to give shareholders the right to include director nominees in the company’s proxy materials.

When a shareholder approaches a company’s board with the suggestion that board nominees to be added to the company proxy, the board should consider, and seek external legal and governance advice to support its consideration of, a number of issues, such as:

- the shareholder’s motives for board representation (i.e. short-term profit vs. long-term viability)
- the perceived ability of the proposed nominee(s) to govern in the best interests of the company as a whole
- the impact on other shareholders

¹¹ If the issuer has chosen not to adopt a majority voting policy, the issuer would be required to explain why not and to explain what its practices are for electing directors. Furthermore, issuers will need to advise the TSX if a director receives a majority of withheld votes and disclose the voting results of the election of directors.

¹² Effective June 30, 2014

¹³ Fasken Martineau, *Shareholder Activism: Trends in Canadian Proxy Context and Canadian Pacific Railway Case Study*, February 7, 2013.

- the skills and personal characteristics of the proposed nominee director(s), and
- the impact on the board's culture and dynamics

In Canada, some companies have begun implementing advance-notice bylaws (and in some cases, advance-notice policies), a practice that has been used by public companies in the United States for a number of years. Once enacted, an advance-notice bylaw ensures that all parties (including the board and other shareholders) have sufficient time to respond to proposed director candidates put forward by a shareholder. This approach has received positive support from proxy advisors.

4. What information should be covered with director candidates upon their election to the board?

During discussions leading to an invitation to join a board, it is important to set out for the director candidate the key expectations associated with the position. These expectations should be revisited upon the candidate's election to the board. While much of the relevant information may be set out somewhere in the board's policy manual, some boards choose to highlight important issues in an appointment letter. Items to be covered in such a letter would include:¹⁴

- terms of appointment
- expected time commitment
- duties
- remuneration and expenses
- independence and outside interests
- confidentiality
- rules regarding insider trading and company policy on disposition of shares
- orientation program
- peer evaluation process for board, committees and individual directors
- ongoing education
- insurance and indemnity
- ability to seek independent professional advice in certain circumstances
- requirement to notify the company of a change in personal circumstances

¹⁴ For further guidance, see the Institute of Chartered Secretaries and Administrators ("ICSA") Guidance Note 111214, December 2011.

- return of property upon conclusion of appointment
- conflict of interest
- data protection
- applicable law

5. What compensation should be paid to directors?¹⁵

An appropriate directors' compensation plan should serve to attract and retain qualified individuals, underscore the requirement for accountability and compensate directors for value received.

The two most common methods of payment are a flat fee (where the director is paid a fixed amount for annual service) and a combination of a retainer and a meeting fee (where the director is paid an annual retainer plus a per-meeting fee). The trend, for larger companies in particular, is towards a flat fee, which is easier to administer, particularly where the work of the board is expected to remain relatively constant throughout the year. The flat fee also eliminates the need to define what constitutes a "meeting," or establish different fees for differing lengths of meetings. Many boards provide for the payment of a special fee when a director is asked to conduct special ad hoc business on behalf of the board outside of regular meeting or committee duties (e.g. a special investigation).

It is common to differentiate directors' pay based on the individual directors' board responsibilities. This differentiation might take the form of additional pay for committee service, committee leadership and board leadership.

Virtually all directors are reimbursed for reasonable expenses incurred while on board-related business. In today's electronic environment, it is common to provide directors with an electronic device (e.g. an iPad) for the receipt and processing of board materials and to reimburse them for any extra technology costs they incur.

The board is responsible for determining the directors' compensation program. Since this arrangement contains an inherent conflict, the recommended practice is for the board to disclose the method of determining compensation and include the identity of a referenced peer group. A fair compensation program will balance the interests of shareholders with the

¹⁵ For a more fulsome discussion of this topic refer to CPA Canada: *20 Questions Directors Should Ask about Compensation*.

expertise and time commitment required of directors and the important stewardship role the board plays. According to the Canadian Coalition for Good Governance:

“While director compensation should be sufficient to adequately reward directors for their expertise and experience and the time devoted to the company, it should not be so high as to potentially compromise the independence of directors, their ability to take a controversial stand on an important issue or their preparedness to resign on a matter of principle.”¹⁶

The quantum of compensation payable to directors has increased significantly over the last decade, reflecting increased workload and exposure to financial and reputational risks.

In order to align directors' interests with shareholders' interests, it is common for boards to mandate that a portion of compensation be taken in shares or share equivalents and that directors achieve a minimum equity stake in the company. The most common equity component is share equivalents, followed by stock options and shares.

16 Canadian Coalition for Good Governance, Policy on Director Compensation (February 2011).

Sustaining the Board (Skills, Leadership and Culture)

Good boards rarely just happen. The best boards are created by bringing together a group of committed individuals with knowledge, interest, skills and experience relevant to the needs of the company and personal attributes that support a high level of team functioning.

When considering directors' qualifications, the composition of the board should be considered from the following perspectives:

- specific skills and experience relevant to the company's opportunities and risks
- personal attributes of individual directors
- board leadership requirements
- committee requirements
- desired aspects of board diversity, and
- establishing a strong, healthy board culture

6. What skills and experience should directors have?

One of the most critical factors in board effectiveness is ensuring that, collectively, the individuals around the table bring a broad portfolio of skills and experience relevant to the key board responsibilities: strategy, risk management, corporate performance oversight, human-capital oversight, business ethics and integrity, and internal controls, among others. As companies evolve, the issues they face, and hence the skills required on the board, will change. It is therefore important that boards establish a culture of renewal by which directors embrace, rather than resist, the required turnover.

Similarly, evolving regulatory requirements may affect a board's responsibilities and, hence, the mix of skills that the board requires. For example, the new Corporate Governance guideline published by the Office of the Superintendent of Financial Institutions (OSFI), in January 2013, placed an increased emphasis on risk management (among other things) in federally regulated financial institutions, thereby heightening the requirement for financial-industry and risk-management expertise on the boards of those entities.¹⁷

The types of skills and experience required on the board must be carefully considered in light of the board's needs. Backgrounds that are in demand in today's environment include:

- industry-specific knowledge
- executive leadership
- financial expertise¹⁸
- global experience and contacts
- operations
- governance / committee experience
- regulatory
- strategy development
- risk management
- technology / IT / social media / IT security
- marketing / public relations
- corporate social responsibility
- government relations
- human resources and compensation
- mergers and acquisitions

It is important that a number of board members bring experience in the company's industry area to bear, so that they understand the competitive environment in which the company operates and have the ability to ask management industry-specific questions. In fact, according to a recent US survey conducted by Deloitte and the Society of Corporate

¹⁷ In an advisory published in January 2014, OSFI confirmed its requirement that regulated financial institutions should notify OSFI as soon as a preferred nominee for director election is identified and provide OSFI with the candidate's *curriculum vitae*, the rationale for the candidate's selection and the effective date of the proposed appointment.

¹⁸ Members of audit committees must be financially literate. According to NI 52-110, a director is financially literate if he or she has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are reasonably comparable to the breadth and complexity of the issues that can be expected to be raised by the issuer's financial statements.

Secretaries and Governance Professionals, industry experience was identified by directors as the most important skill or experience required to contribute to their board's success in the next two years.¹⁹

It is important to note, however, that a base of knowledge, even if in a sought-after area, is not enough to make a good director. The best directors have a depth and breadth of experience through a recent executive or other relevant leadership role that enables them to understand the business, the sector and the wider environment, and enjoy the respect and confidence of management and their fellow directors.

One caveat regarding directors' skills: it can be problematic if an individual is brought on board because they have deep expertise in one particular area but they cannot contribute more broadly to the issues facing the board. As such, although it is important to evaluate a potential director's skill set relative to the board's specific needs, the suitability of each candidate should also be considered within the broader context of their overall ability to contribute.

Many boards would prefer a director with business and executive leadership experience over one who was deep in a subject area but lacked the wisdom and judgment that comes from broad senior leadership experience. Historically this preference has resulted in a high number of CEOs being appointed to boards. In today's environment, however, where fewer CEOs are available or willing to serve on boards, boards are successfully turning to executives below the CEO level for executive leadership expertise.

7. What personal characteristics should directors possess?

Finding directors with the required skills and experience is only half the equation. Equally important, if not more so, are the personal characteristics of the individuals chosen to sit around the board table. Important personal characteristics include:

- **Integrity**—an innate adherence to ethical conduct and values
- **Accountability**—taking responsibility for one's own actions
- **Courage**—the ability and willingness to voice an opposing point of view
- **Mature leadership**—experience-driven perspective and self-awareness of emotional patterns and triggers

¹⁹ Deloitte Center for Corporate Governance and the Society of Corporate Secretaries and Governance Professionals, *2012 Board Practices Report—Providing Insight into the Shape of Things to Come*, p. 8.

- **Strategic perspective**—ability to generate and apply unique business insights to challenges and opportunities, ability to challenge conventional thinking
- **Good communicator**—expresses thoughts and ideas clearly and with respect for the views of others; listens actively
- **Influencer**—has credibility with management and other directors
- **Commitment to the company**—is passionate about the success of the company and believes that good governance has an impact
- **Business acumen**—track record of wise business judgment
- **Fiduciary duty**—strong understanding of fiduciary responsibility to the long term sustainability of the company (and shareholder value)
- **Independence of mind**—speaks his or her mind honestly on all issues
- **Active participant**—comes to meetings fully prepared, listens and speaks up
- **Team player**—committed to the role of the board as a whole, works to resolve issues, treats others in a respectful and supportive manner, is flexible in arriving at solutions

Directors set the “tone at the top” and it is important that all directors exhibit values consistent with the company’s own values (e.g. integrity). It is important that directors bring a strategic perspective and use their external business experience to quickly connect the dots when considering issues of strategy and risk (required characteristics: strategic thinker, business acumen). Directors must be able to work well in a team and have the courage to speak their mind (required characteristics: mature leadership, good communicator, influencer, independence of mind, active participant, team player). Some would say that our boardrooms have placed too much emphasis on collegiality and that the pendulum must swing to recognize the value of the constructive debate and the role of a director who is a constructive contrarian. And finally, directors must all have a strong commitment to the long-term sustainability of the company (required characteristics: commitment, fiduciary duty).

Modern thinking on board composition supports the role of a “constructive outlier”—a contrarian who can, and is willing to, bring a different perspective on issues under consideration and challenge management or other directors. Such an individual should not be seen as a threat to collegiality but rather as someone who can be a strong contributor to the board’s deliberations and help the board to exercise its duty of care.

8. What leadership positions are required on the board?

It is important that at least some of the members of a board—including the board chair and committee chairs—have both an interest in and the skill required to assume leadership positions. Accordingly, when considering its needs, a board must not only take skills, personal attributes and diversity into account; it must factor in leadership potential as well.

Although approaches to governance are often quite similar in Canada and the United States, leadership structure is one area where practices diverge somewhat. In the United States, it is still common practice for companies to combine the board chair and CEO roles, whereas in Canada the two roles tend to be separate. When the board chair and CEO roles are combined, a board generally appoints an independent “lead director” to chair *in camera* sessions of the independent directors, act as the primary liaison between the independent members of the board and the CEO, and ensure the board’s effectiveness.

Although a majority of public companies in the United States currently have a single chairperson / CEO,²⁰ the trend is moving downward. It is anticipated that in the coming years the number of companies with the combined role will decrease further, as shareholder activists continue to call for a separation of these roles. In Canada, separation of the Chair and CEO role is seen as an essential component of good governance.

a. What are the key skills and attributes required of a board chair?

The skill of the board chair is a key determinant of the overall effectiveness of a board.

A good board chair ensures that:

- the right issues are on the agenda
- the right information is put before the board
- directors contribute in a meaningful way
- the board culture is conducive to challenging debate and decision-making
- there is a healthy, constructive relationship between the board and the CEO

²⁰ According to the 2011 Spencer Stuart US Board Index, 59% of the S&P 500 have a combined CEO/Chairperson role, down from 73% in 2003.

Not every individual is suited to be a chair. The individual in that seat must not only have the time to devote to the role but also the necessary personal skills to identify key issues, lead meetings, gauge the culture in the boardroom, build consensus and ensure appropriate follow-up and action. The board chair sets the tone in the boardroom and must create an environment that is conducive to full engagement by board members, particularly on sensitive or challenging issues.

While many boards have position descriptions that set out the board chair's responsibilities, it is also useful for boards also to identify the desirable attributes that anyone filling this role should possess. The resulting list of attributes will be particularly useful with respect to the board-chair succession process (discussed more fully in Question 18, below). Some attributes (e.g. time, required level of commitment, integrity, being a consensus builder, having business credibility and the ability to engender trust and respect) will remain consistent, whereas others (e.g. credibility with regulators, credibility with investors, mergers and acquisitions, governance, entrepreneurial) will change or become more important, depending on the company's focus and the anticipated involvement of the board chair.

An essential element of strong board leadership is the ability to foster a constructive and productive working relationship with the CEO. This requires the chair to be collaborative with the CEO yet also retain sufficient independence so that the chair can challenge the CEO and address difficult issues.

b. What is the role of a lead director?

National Policy 58-201 provides that the board chair should be an independent director and, where this is not appropriate, the board should appoint an independent director to act as "lead director." In the US, where a high number of companies combine the chair / CEO role, there is an increasing prevalence of lead directors. Although in Canada it is more common for companies to have an independent non-executive chair, lead directors are typically found where a major shareholder occupies the board chair position or there is a combined chair / CEO role.²¹

21 Proposed amendments to the *Canada Business Corporations Act* require that distributing corporations either separate the functions of board chair and CEO or, where the positions remain integrated, provide for an independent lead director.

The lead director's role is to work closely with the board chair to assist in managing the board's affairs. This includes being satisfied that the board is organized properly, functions effectively and operates independently of management.

The responsibilities of a lead director may include:

- chairing *in camera* meetings of the independent directors
- acting as principal liaison between independent directors and the board chair and / or CEO
- establishing, in consultation with the board chair and CEO, the frequency of board meetings
- setting agendas for board meetings, in consultation with the board chair and CEO, to ensure that critical issues are included
- providing feedback to the board chair on the quality and timeliness of information from management
- coordinating the activities of the independent directors
- overseeing board and directors' evaluations
- recommending committee membership to the board chair
- playing a lead role in the evaluation of the CEO
- representing the board, as appropriate, and
- facilitating communication between the board and investors, as appropriate

9. What skills are required of directors doing committee work?

In today's governance environment, committees have become an important part of a board's governance structure, assisting the board to carry out its responsibilities in specific subject areas. The three most common committees are audit, governance / nominating and compensation / human resources, although, depending on the company, it is also common to see committees such as risk and environment, and health and safety. As part of the board-building process, it is important to ensure that there are individuals on the board who can lead the committees and fulfill committee needs.

Audit—In Canada, corporate governance guidelines require that audit committees be composed of at least three directors who must meet an enhanced “independence” test and be financially literate.²² The broad areas of audit committee responsibility include overseeing:

- the work of the external auditor
- the integrity of the financial reporting process and financial statements
- the process for monitoring compliance with laws, regulations and code of conduct
- systems of internal controls
- internal audit, and
- risk management (unless assigned to a separate risk committee)

Boards of Canadian financial institutions are required to establish a conduct review committee to carry out responsibilities under applicable legislation (e.g. the *Bank Act*). Some financial institutions combine their conduct review committee with their audit committee or another relevant committee.

Governance / Nominating—Canadian public companies should have an independent nominating committee tasked with identifying qualified individuals to stand as candidates for election to the board. Many companies combine their nominating committee with their governance committee, and give that joint responsibility for the overall approach to governance (including oversight of the processes that support and evaluate the effectiveness of the board, committees and individual directors).

Compensation / HR—Canadian public companies should have an independent compensation committee²³ that is responsible for leading the board’s processes relating to the compensation and evaluation of the CEO and succession planning, as well as significant human capital issues.

Risk—Following the recent global financial crisis, the major Canadian banks and many other Canadian and foreign financial institutions established risk committees responsible for assisting the board in fulfilling its oversight responsibilities for the companies’ identification and

22 Similar requirements are set out in the US under the *Sarbanes-Oxley Act*.

23 Similar requirements are set out in the US under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.

management of risk, adherence to corporate risk management policies and compliance with regulatory requirements. Some companies in other industries have also established such committees.²⁴

Environment, Health and Safety—Depending on the sector and environment in which a company operates, it may also be prudent to have an environmental, health and safety committee, responsible for assisting the board’s oversight of the company’s approach to environmental and occupational health and safety matters.

Whether a board maintains additional standing committees (e.g. finance, pension, investment, reserves, executive) will depend on the company’s particular needs. For the last several years in Canada, boards have averaged four committees.²⁵

Although the use of executive committees used to be widespread, today they are much less common. A key concern with executive committees is that they can create a “super board” and marginalize those directors who are not executive committee members. Developments in technology have also reduced the need for such a committee as the full board can come together as necessary between regular board meetings via teleconference and other electronic means. Where executive committees still exist, their duties are usually quite narrow.

It is important that each committee is composed of the “right” directors having the appropriate skills and experience to carry out the committee’s mandate. Committee appointments should be made by the board as a whole, based on the recommendation of the board chair or the governance / nominating committee. Care should be taken to ensure that the committee chair demonstrates similar leadership attributes to those sought in the board chair (see Question 8, above).

10. Does diversity matter?

Diversity in the boardroom is not, nor should it be, about tokenism. It is an acknowledgment by a board that, in order to be successful, it needs the best possible people around the table—people who will bring different perspectives to bear and stimulate curiosity, debate and constructive challenge.

24 Even where companies have not established a risk committee, the increased focus on the board’s responsibility for risk in general has heightened the focus of risk management as an important board competency.

25 Korn Ferry, O’Callaghan, *Corporate Board Performance and Director Compensation in Canada: A Review of 2012*, page 47.

Although “diversity” can mean many things (i.e. diversity can be a matter of views or perspectives, gender, age, ethnicity, geography or skills), it is gender diversity that has of late attracted the most attention in the context of board composition. In an effort to increase the number of women on boards, many jurisdictions (such as Norway, Iceland, France and Spain) have introduced mandatory quotas. Other jurisdictions (such as Australia and the United Kingdom) have taken other “softer” measures, such as requiring companies to disclose their diversity policies and progress towards self-imposed diversity targets.

Until recently, legislators and regulators in Canada (except for the Quebec government²⁶) had not demonstrated any appetite for quotas in the boardroom (gender-based or otherwise). However, following an Ontario government initiative, and extensive consultation, recent amendments to Form 58-101F1 by the Ontario Securities Commission and several other members of the Canadian Securities Administrators²⁷ require non-venture issuers to provide annual disclosure in the following areas:

- term limits
- policies regarding the representation of women on the board
- consideration of the representation of women in the director identification and selection process
- consideration of the representation of women in executive officer positions
- targets adopted regarding the representation of women on the board and in executive officer positions
- the number of women on the board and in executive officer positions
- measurement regarding the representation of women in the organization and, specifically, on the board and in senior management

Today, there is a growing agreement among directors and governance experts that diversity in the broadest sense is important for a number of reasons. First, diversity minimizes “groupthink”; it allows boards to consider issues from a variety of additional perspectives. According to a recent study of Canadian directors undertaken by the Institute of Corporate Directors, nearly 80 per cent of respondents believed that board diversity contributes to better decision-making.²⁸ Second, the diversifica-

26 In 2006, the Quebec government legislated a requirement that 50 per cent of provincial Crown corporation board seats be held by women; as of 2012, female board representation was up to 52.4 per cent from 27.5 per cent in 2006.

27 Saskatchewan, Manitoba, Quebec, New Brunswick, Nova Scotia, Newfoundland and Labrador, Northwest Territories and Nunavut.

28 Institute of Corporate Directors, *Diversity in the Boardroom: Findings and Recommendations of the Institute of Corporate Directors*, December 5, 2011, p. 5.

tion of boards deepens the pool of qualified director candidates. Third, a commitment to diversity by an organization can communicate a message to shareholders, customers, employees and other stakeholders about the company's values, ethics and social commitment.

A board interested in making a commitment to diversity should take the following steps:

- Define what “diversity” means in terms of its company's particular context and needs
- Adopt and disclose a board diversity policy that sets out specific targets
- Describe its practices with respect to the consideration and promotion of diversity in board recruitment efforts
- Implement term limits, retirement ages and/or rigorous evaluation processes to promote healthy board renewal and new directorship opportunities
- Look outside its traditional networks when searching for new director candidates to ensure the best possible talent in diverse categories (see Question 16, below), and
- Ensure all candidates have the required welcome and support when they join the board, so they can get up to speed as soon as possible

11. What information is required to adequately orient new directors?

Boards should ensure that all new directors receive a comprehensive orientation, so that each director understands the role of the board and its committees, along with the contribution expected of individual directors. The orientation should also ensure that the director understands the nature and operation of a company's business. If the director is appointed to a board committee, they should also receive a detailed orientation regarding the functioning and specific duties of that committee.

It is typically the board's governance committee that is responsible for ensuring that each new director is sufficiently oriented. Many boards try to deliver their orientation program in separate components over the course of the director's first few weeks or months on the board, so as to avoid overwhelming the director with too much information in a short period of time. Although the orientation should be mandatory for all new directors, it is a good idea to extend an invitation to all current directors

to attend any (or all) components of the orientation. It is invaluable for new directors to get face-to-face time with members of management and other directors.

One additional recent trend is the implementation of director-mentoring programs, whereby a new member of the board is matched with a director with prior experience. The seasoned director can act as a resource and advisor at the start of the new director's tenure, be available after meetings to answer questions, provide advice and direction as required and assist the new director in accessing resources and information as needed.

12. What kind of continuing education is important for directors to pursue?

In addition to a comprehensive orientation when joining the board, directors should ensure that they continually enhance their knowledge base relevant to the needs of the board. This may involve education on macro issues (e.g. industry trends), the business (e.g. site visits, presentations from executives), governance (e.g. trends in CEO succession planning) and specific committee responsibilities.

Educational topics should be designed to keep directors current on issues of importance and help prepare them for conversations around strategic or risk-related issues. Some boards will set educational goals for the year, whereby they seek to spend a certain amount of their time together (e.g. 10 percent) on educational matters.

It may well be the case that educational needs will vary between directors. A well-designed continuing education policy will ensure that each individual director's continuing education plan is tailored to their specific needs.

13. How do directors' qualifications and attributes affect a board's culture?

Boardroom culture has been defined as “the body of accumulated beliefs, assumptions, attitudes, values, and experiences of a board's directors that collectively manifest in decorum, protocol, norms and the concentration of power.”²⁹ Although culture is a “softer” component of governance that is difficult (if not impossible) to regulate through guidelines and rules, the culture in a boardroom is increasingly recognized as one of the key

29 Patrick R. Dailey, *The Anatomy of Board of Director Culture*, European Business Review, November/December 2011.

factors determining a board's overall effectiveness. Culture can be positive (it helps the group be high-performing), or negative (it detracts from high performance).

Board members are a group just like any other, and every board's performance will be highly influenced by its culture. No board is the same; each is made up of a unique set of individuals with diverse relationships, attitudes, experiences, beliefs and priorities.

In order for a board to have a high-performance culture, board members must have relevant experience, mutual respect, positive chemistry, an attitude of vigilance and constructive challenge, high engagement and a common focus on the success of the company. When these group dynamics are present, the board is more likely to engage in the level of robust constructive challenge and debate that is required to dig into issues and drive the company's performance.

Characteristics of a poor board culture include:

- a domineering board chair
- deference without challenge to an outspoken member of the board
- deference without challenge to the CEO
- subtle, or not so subtle, messaging to a director that certain questions are not welcome
- conversations taking place outside, rather than inside, the boardroom
- attacking a person rather than attacking the concept or idea
- arrogance
- hidden agendas
- personal loyalties that outweigh honest debate

The board chair plays a key role in setting the tone of the boardroom and establishing a high-performance culture. While a well-structured decision-making process is important, the chair must ensure that the board is aligned on direction and purpose, that board members interact with respect, that each member contributes vigorously and that debate and challenge are welcomed. Positive chemistry among board members does not mean groupthink. On the contrary, positive chemistry means a feeling that it is safe (and encouraged) to express opposing views and to challenge.

Some boards explicitly discuss their desired culture and express it in writing. The process of discussing expectations regarding board functioning is healthy in itself. In addition, the expected standards of behaviour can

be referenced by the board chair (or an individual director) when necessary, and a benchmark set which can be considered in the annual board and peer evaluations.

In today's environment, boards are expected to execute their responsibilities with dynamic vigilance. Therefore, when recruiting new board members, it is important to assess not only their individual experience but also their potential contribution to a high-performing culture.

14. What time commitment is expected of directors?

Boards today face greater scrutiny than ever before and the commitment required of directors continues to increase. As for the time required, it is not uncommon to hear estimates in the range of 200 to 250 hours per year for a director, and even more for directors in leadership positions (e.g. board chair, committee chairs). Directors are expected to attend board meetings and meetings of the committees on which they sit. They are expected to put in time before meetings to prepare and stay abreast of matters affecting the company between meetings. In addition to their regular duties, board chairs are often called upon to serve as *ad hoc* members of the board's committees and attend committee meetings.

Given the increased workload associated with a directorship, many boards are placing restrictions on their directors regarding other directorship positions. In the United States, 74 per cent of S&P-500 companies limit other corporate directorships for their board members—some put restrictions in place for all directors and others do so only for directors who are fully employed by public companies.³⁰ These kinds of restrictions help to ensure that directors are able to put in the time required when elected to a board. They also provide a further rationale for going outside the traditional network when seeking new director candidates.

If a board is involved in a crisis, an acquisition or takeover or some other situation requiring extended board attention, the time required of a director can increase substantially.

30 Spencer Stuart US Board Index, 2012, p. 16.

Renewing the Board (Succession Planning)

Historically, directors who were elected to a board were guaranteed re-election for as long as they wished to serve. In today's environment, boards are more alert to the need to refresh board membership, to bring in required skills and to ensure continued vigilance in carrying out the board's responsibilities. It is important for boards to consider their approach to board succession, including the relationship between succession, director peer evaluation, mandatory retirement age and maximum term limits.

15. How should a board plan for succession?

There is no one right approach to board succession. On one hand, the regular and planned turnover of board membership is seen as healthy — it counteracts complacency, provides an injection of new ideas and allows the board to adjust its membership as required relative to the company's changing circumstances. On the other hand, continuity and continued contribution from trusted, high-performing directors provides valuable stability and steady guidance and leadership.

Boards should take a leadership role with respect to their own composition and succession.³¹ A healthy approach to board succession involves two considerations: ensuring that the board has the skills and experience it needs to carry out its responsibilities; and ensuring that it maintains a dynamic, vigilant culture. Turnover, and the injection of new ideas and perspectives, can contribute positively to a high-performing culture. Needless to say, the need for succession should be evaluated regularly

³¹ Canadian companies should refer to National Policy 58-201—Corporate Governance Guidelines, Nomination of Directors.

and, when rotation is seen as being in the best interests of the company, it must be done. This type of conversation falls into the category of “simple, but not easy,” but the board chair or nominating committee chair must have the courage to initiate difficult conversations when required.

In order to create an environment where nominating committees are empowered to make necessary decisions on succession, it is important for boards to establish a “succession culture” whereby regular turnover is expected, and to outline when and how those decisions are made. New board members must be made aware of the board’s approach at the time they join the board. Many boards consider succession planning to be a multi-year process, where potential candidates are identified and approached well before their anticipated term would begin (i.e. two years or more beforehand).

The board must establish a regular schedule and process for assessing its needs and the contribution of sitting directors; the findings of such an assessment will inform the decision as to whether or not turnover is required. The end of the annual strategy discussion, when the board has just reviewed all aspects of the external environment and its key strategic issues and risk profile, may prove an optimal time to conduct this board-composition assessment. Scheduling the review at this time will help the board to consider the priority skills and experiences it requires to continue to be a value-adding asset to the company.

As far as process is concerned, many boards use a board competency matrix to assist them in assessing their future needs and planning for succession. A competency matrix is a simple-yet-effective tool that allows a board to identify the:

- “needs,” i.e. the skills and experience, leadership, committees and diversity that the board requires
- skills and experience of current members, and
- “gaps” that should be filled to strengthen the board

A sample competency matrix is attached to this publication as Appendix A. A board should review and update its matrix on an annual basis. As mentioned above, a good time to review the matrix is shortly after the annual strategy session, to ensure that the board’s skill set can address the issues important to the company’s strategy and risk assessment.

The board may wish to seek input from the CEO and key stakeholders when identifying the board's priority "needs." Once the required skills and other attributes have been identified, the board's nominating committee can be tasked with populating the matrix. The committee should mark the competencies of each continuing director and circulate the completed matrix to all directors for their approval. Once the competency matrix has been reviewed and approved, it can serve as a guide in identifying potential candidates who could fill the board's "gaps." Another effective way to populate the matrix, as part of the board or director evaluation process, is to ask each director to rate the other directors' perceived areas of contribution.

Finally, although the focus on priority skills and experience is important, the board must consider other dynamics, such as corporate memory and group functioning. On one hand, the benefit of changing board membership to add skills may be outweighed by the negative impact on group dynamics; this may be an especially important consideration if the company is going through a period of instability and would benefit from board continuity. On the other hand, in today's dynamic environment, companies may require new skills to keep up to date. As with many decisions, the board must balance the pros and cons of change.

It is considered best practice today for boards to disclose their matrix, recruitment practices, and their directors' backgrounds to demonstrate how their directors satisfy the board's stated needs.

16. Should there be limits on directors' length of service?

Recent amendments to the TSX Company Manual require that directors be elected on an annual basis. Accordingly, it is no longer possible for boards of companies listed on the TSX to maintain "staggered" terms for directors. The requirements of the TSX Company Manual, however, do not prohibit directors from being re-nominated; and, provided that a director is re-elected on an annual basis, they may serve on the board for multiple terms. The question then becomes whether a board should self-impose limitations on a director's total length of service in the name of good governance.

Typical arguments in favour of extended director service have to do with the director's knowledge of the company and the difficulty in finding a replacement. Arguments against lengthy service rest on an understanding

that, after time, a director becomes complacent, may be less engaged in outside business activities due to retirement, and lose independence from the CEO because of the long-standing relationship between them.

Historically, many boards introduced a mandatory retirement age, to serve as an artificial end-date and provide a graceful exit for directors who were no longer contributing. In Canada, while it is not mandatory to disclose retirement-age policies, those companies that have disclosed this information indicate that the typical mandatory retirement age is between 70 and 75, with the most common being 72.³² In the US, mandatory-retirement age limits remain popular, with the most common age limit being 72, although the limits are increasing as companies move their retirement ages up.³³

In recent years, due to the increased emphasis on individual directors' contribution and active board renewal, many have questioned the effectiveness and relevance of having a mandatory retirement age. Instead, they assert that the focus should be on a director's level of contribution rather than their age. Once a director ceases to contribute at an acceptable level, regardless of age, they should retire from the board. Directors' contribution can be assessed through a regular, formal director evaluation process, such as a peer review (see Question 17, below). Whether this approach is effective will depend in large part on whether the board commits to participating in meaningful evaluation processes, and whether the board has the courage to use the results when determining whether a director ought to be re-nominated for continued service.

While there has been historical resistance to imposing term limits, there is increasing momentum in favour of this approach. While term limits remain more popular in not-for-profit or public sector companies, there is a move towards the imposition of term limits within Canadian public companies, with several of the banks, as well as a few other large companies, having imposed term limits. Where term limits are imposed, the term is typically between 10 and 15 years.³⁴

As stated above, the UK Governance Code creates a presumption against independence once a director has served nine years, although boards have the option to justify why a director remains independent. Some

32 Korn Ferry, O'Callaghan, *Corporate Board Performance and Director Compensation in Canada: A Review of 2011*, p. 8.

33 Deloitte, *2012 Board Practices Report (US)*, p. 20.

34 Korn Ferry, O'Callaghan, *Corporate Board Performance and Director Compensation in Canada: A Review of 2011*, p. 10.

boards are also considering this approach to ensure that more board seats will open up, so they can advance their diversity goals. The proposed amendments to Form 58-101F1 would require “disclosure requiring director term limits or an explanation for the absence of such limits.”

As with mandatory-retirement age limits, the imposition of director term limits is a useful tool to assist in the process of regular board renewal. However, term limits should not be a substitute for a rigorous director evaluation process and the courage to renew the board as and when required depending on the board’s needs and individual directors’ performance.

17. What is the relationship between individual director evaluation and board renewal?

Good practice dictates that boards undertake an annual evaluation of the board as a whole, the board chair, committee chairs and each individual director.³⁵ The evaluation of the board as a whole can help a board identify those skills and experience “gaps” that should be filled by new director candidates. The individual-director evaluation provides insight into the perceived effectiveness and contribution of each director.

Some boards approach individual-director evaluation as a development tool only and do not link the results to continued board service. However, the increasing trend is to use the individual-director evaluation process to inform the decision as to whether a director ought to be re-nominated for continued service. If the director is neither seen as effective nor as a contributor at the board table, and this is not a performance issue that can be corrected, the director is advised that they will not be re-nominated.

The dual-track process of evaluating the board’s needs (skill sets) and each director’s personal contribution is a comprehensive, structured way for a board (or nominating committee) to make well-informed decisions about board succession and turnover.

³⁵ For a fuller discussion of board and director evaluation, refer to CPA Canada: *20 Questions Directors Should Ask about Board Evaluation*. In Canada, see also National Instrument 58-201—Corporate Governance Guidelines (3.18) which provides:

3.18 The board, its committees and each individual director should be regularly assessed regarding his, her or its effectiveness and contribution. An assessment should consider
 (a) in the case of the board or a board committee, its mandate or charter, and
 (b) in the case of an individual director, the applicable position description(s), as well as the competencies and skills each individual director is expected to bring to the board.

While the concept and theory of linking individual-director evaluation to board renewal is well supported, it is recognized that not every board is well equipped to carry out this task. In order for a board to rely on individual-director evaluation as the key factor in director re-nomination and board renewal, the evaluation process must be sufficiently comprehensive to provide useful, reliable feedback, the person overseeing the process (typically the board chair) must be able to manage the process personally and deliver the message without being unduly influenced by personal relationships. As well, the culture of the board must support the overall approach.

18. How should a board plan for board-chair succession?

Given the critical role that the board chair plays in the overall effectiveness of a board, the consideration given specifically to board-chair succession is an essential element of board succession planning. Board-chair succession can sometimes be a delicate issue for boards, particularly when an individual has been in the role for a number of years, or when a long-standing director feels that it is their “turn.” The best way to avoid these kinds of issues is to ensure that the board has in place a comprehensive “job spec” for the board-chair position, a formal process to evaluate the board chair, and a board-chair succession policy.

As noted above, it is good practice for a board to articulate in writing, either in the board-chair position description or in a board-chair succession planning policy, not only the job description (the board chair’s role and responsibilities), but the desirable attributes and skills that the individual assuming this role should have. The desired attributes can be used as a basis for identifying those candidates on the board who should be considered as future chairs and to choose an incoming chair when a transition is in order.

It is also a good idea to establish a formal board-chair succession policy, that sets out the procedure to be followed when selecting a new chair, and who will be responsible (e.g. the governance / nominating committee or a task force of all directors who are not seeking the position) for leading it. The board should also consider whether the board chair serves for a specified term or, if not, how and under what circumstances a change in board chair is initiated.

A sample approach to board chair transition would be as follows:

- Identify the key skills and attributes the new chair should have
- Seek input from all board members as to their interest in the position and whom they would support in the role (e.g. the governance committee chair or other trusted senior member of the board who is not seeking the position)
- If consensus on one director is reached, and that person is willing to serve, let that be known and the transition will happen accordingly
- If there is no consensus, and multiple people are interested in the position, either conduct a series of further conversations to help the board move towards consensus, or alternatively, manage a process which allows persons seeking the position to address the board, with a subsequent vote by secret ballot (e.g. the governance committee chair or other trusted senior member of the board who is not seeking the position) determining the outcome.

On an ongoing basis, it is important to conduct an annual, formal board chair evaluation. The evaluation results should be provided to the governance committee chair and shared with the entire board. A growing trend is for the board, in the absence of the board chair, to discuss the board chair evaluation results. The purpose of the evaluation should be to provide useful feedback to the board chair in relation to performance. At some point, the feedback may also trigger a discussion among board members as to whether a change of chair might be required.

19. How can director candidates be found?

A board is only as good as its individual members. Therefore, the process of identifying and evaluating potential director candidates is critical to building a high-performing board. With the heightened focus on the importance of individual directors' contributions, boards have become much more thoughtful about how they will go about identifying potential director candidates to fill their needs.

Historically, many boards relied on the networks of current directors (and the CEO) to find new director candidates. While the majority of board members today are still identified through personal networks, it is increasingly more common for nominating committees to engage the services of a search firm when seeking qualified director candidates. It is recognized that in order to find the best possible candidates, it is necessary and desirable to cast a wider net than might once have

been the case and to bring about a more structured and disciplined approach to the recruitment and evaluation processes. Also, as more and more CEOs reduce their number of outside board commitments, more extensive investigative work is required to identify an expanded pool of potential candidates.

The nominating committee plays a critical role in the approach to director recruitment. It is essential that those serving on this committee are prepared to conduct an independent, objective and far-reaching search in order to identify the best available candidates for consideration.

A good search firm can support a board in identifying its needs and proactively targeting those individuals who are specifically suited for the opportunity at hand. It is important that the search firm understand board responsibilities and effectiveness and be well connected in the director marketplace. It is also important that the search firm be aligned with the board's approach to director recruitment (e.g. its approach to diversity, for example), and that the firm not be conflicted by work they may be performing for other boards or for the company itself. Even though a search firm may be engaged, it is important that the nominating committee, whose members best understand the need and board dynamics, retain leadership of the search.

The typical steps in director recruitment are to:

- Develop a “role spec” (itemize the skills and experience, personal attributes, leadership experience and contribution to diversity)
- Develop a target list of industries, companies and executives to be investigated, including recommendations from directors and management (and potentially from shareholders and / or other relevant stakeholders)
- Identify priority candidates and ascertain their time availability, interest and potential conflicts
- Evaluate candidates against the role specification
- Make the invitation and confirm the terms of appointment

There are a number of new databases³⁶ of individuals seeking board positions. While this is one source of potential candidates, boards will want to ensure that the breadth of their search is commensurate with the requirements of the position it is seeking to fill. Boards should

³⁶ ICD Directors Register, Directors College website and Canadian Board Diversity Council “Diversity 50” are three examples.

maintain an evergreen list of potential candidates and boards; and management should add to that list if and when they meet someone with potential for future board service.

20. How should boards evaluate director candidates?

The evaluation of potential candidates is a critical step in the process. In the past, an invitation to serve on a board of directors was seen as an honour bestowed and accepted. There was little dialogue between the invitee and the director candidate other than to confirm the request and accept the offer.

Today's environment is much different. It is expected that there will be a series of discussions where the fit between the board's needs and the director's qualifications will be explored. There often are several meetings in which each side conducts its due diligence on the other. For some organizations (such as financial institutions), it is increasingly common for criminal record checks to be conducted on director candidates.

It is much easier to invite an individual to join a board than to ask him or her to leave. Therefore, it is important for boards, chairs and nominating committees to put considerable time and thought into the evaluation of potential candidates before extending an invitation to join the board. Typically there are several meetings to review and discuss the company's needs, the director's potential contribution and the fit. Meetings may involve the nominating committee, the board chair and other directors.

Referencing is also a very important part of the process from both sides' perspective. References from board members who have previously served with the candidate can be invaluable in gaining an understanding of the candidate's professional expertise, working style and contribution to the team culture. Referencing can be conducted by a search firm, but it should be conducted by members of the nominating committee as well. Likewise, a director candidate will want to reference the board by speaking with individual members who are currently serving on the board. While the CEO does not typically take a leadership role in board recruitment today, it is important to consider whether a potential candidate will be able to engage in a constructive relationship with the CEO.

In today's environment, it is not just a matter of the company assessing potential candidates. Given the workload and potential personal liability (financial and reputational risk), candidates are interviewing companies as much as the reverse. Today, it is common for director candidates to conduct significant due diligence on a prospective board before accepting a position. Key elements of inquiry for a potential director are set out in Appendix B.

According to a Korn Ferry report, the five key factors in attracting great directors are:

- the company's overall reputation,
- a compelling story and strategic plan
- a strong approach to risk assessment and management
- an effective governance framework, and
- competitive compensation

Conclusion

Getting the composition of a board “right” is arguably the most important determinant of a board’s effectiveness. While boards are expected to comply with regulatory guidelines and listing requirements, experience shows the most effective boards use compliance just as a baseline. They are teams of competent individuals who have relevant skills and experience and bring diverse perspectives to board discussions. They are alert to their fiduciary responsibilities and vigilant in carrying out their duties through the exercise of positive team dynamics. They have the courage to have tough conversations when necessary.

In order to build such a team, boards must expend time and effort on planning for renewal, recruiting and evaluating new director candidates, and ensuring directors get the support they need through adequate orientation and ongoing education. Given the importance of the board’s role in the governance of companies, it is imperative that adequate time and effort be devoted to building, sustaining and renewing the board.

APPENDIX B

Questions and Issues Potential Directors Should Consider Before Joining a Board³⁷

The Business

- Understand the company's background by reading annual reports and any newsletters, media releases or other documents made available to shareholders and / or the public (including the company's website). In Canada, the disclosure documents for all public companies are available on SEDAR: www.sedar.com).
- How does the company make money?
- What is its sustainable competitive advantage?
- What is the biggest challenge facing the company?
- What is its biggest threat?
- What is the biggest opportunity?
- Do you feel confident about the company's direction and what it is trying to achieve?
- Are you confident in the reputation and abilities of the CEO and CFO?
- What is the company's culture?

³⁷ Note that not all companies may be comfortable sharing all of this information at the interview stage and may prefer to wait until orientation.

Strategic Direction and Performance

- Understand the company's strategic and business plans.
- Have there been any serious issues in recent years? If so, how have those issues been handled?
- Are the plans realistic?
- Does the company have comprehensive risk-management processes in place? What is done to monitor their effectiveness?
- Are financial and non-financial performance indicators defined for the company, its employees and management? How does the board monitor these?
- Does the board evaluate the CEO's performance in a formal way?

Financial Position

- Review the company's financial statements.
- What are the current and forecast cashflow, borrowings and interest cover?
- Speak with the chair of the audit committee if necessary.
- Who is the auditor, and are there any current disputes with them?
- What accounting standards and policies does the company use?

The Board

- Review the skills, experience and background of the other company directors and the process by which they were selected.
- Are the board members sufficiently independent (e.g. what is the ratio of executive to non-executive directors)?
- Are you satisfied with the other directors' level of sophistication and expertise?
- What board committees exist? What committee would you be asked to join?
- Are there comprehensive governance policies in place, including a code of conduct?
- What is the culture of the board?
- Is there a collegial yet robust working environment on the board?
- What are the strengths / weaknesses of the board's working relationship with management?
- Does the board evaluate its own performance?

Expected Contribution

- Ascertain what contribution you are expected to make.
- Review the director's terms of reference or charter of expectations.
- If there is a draft letter of appointment, review it.
- Why did the company identify you as a director candidate?

Legal Issues and Liability

- Indemnity /insurance provisions—read the policy and understand any costs involved and whether there are any significant exposures.
- Are there any legal actions or major disputes pending against the company and / or directors, including action by any regulator?
- How does the board oversee risk management?
- What are the company's key environmental or health and safety concerns?
- Can directors obtain independent professional advice at the company's expense?
- Review the company's code of ethics and / or conduct.
- Speak to the external auditors and solicitors if necessary.

Information

- Review the minutes of recent meetings.
- Do the board minutes contain the information you would expect and are they distributed in a timely manner?
- Review recent financial statements for evidence of financial health or stress.
- Are there appropriate internal controls to ensure accurate financial and other information?

Shareholders and Stakeholders

- What is the corporate and ownership structure of the company?
- What is the current attitude of shareholders and stakeholders to the company, board and management?
- What is the attitude of the board to stakeholders?
- Has the company been receiving positive or negative media coverage lately?
- What happens at AGMs and how are they run?

Your Fit with the Company

- Are you comfortable with the people and the way the company conducts business?
- Do you have the expertise (financial, commercial, interpersonal, etc.) expected of you as a director of this company?
- Do you feel you can add value to the board?
- Do you have enthusiasm for the company and share common values with the board and senior management?
- What is the board meeting schedule? What are the expected demands on your time?

Compensation

- Review compensation provisions.
- Are you expected to purchase shares?
- Are you satisfied with the amount of compensation?

Where to Find More Information

CPA Canada Publications on Governance
(available at www.cpacanada.ca/governance)

The Director Series

The 20 Questions Series

- 20 Questions Directors Should Ask about Building and Sustaining a Board
- 20 Questions Directors Should Ask about CEO Succession
- 20 Questions Directors Should Ask about Codes of Conduct (2nd ed)
- 20 Questions Directors Should Ask about Directors' and Officers' Liability Indemnification and Insurance (2nd ed)
- 20 Questions Directors Should Ask about Executive Compensation (2nd ed)
- 20 Questions Directors Should Ask about Governance Assessments
- 20 Questions Directors Should Ask about Governance Committees
- 20 Questions Directors Should Ask about Insolvency
- 20 Questions Directors Should Ask about IT (2nd ed)
- 20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee
- 20 Questions Directors Should Ask about Special Committees (2nd ed)
- 20 Questions Directors Should Ask about Strategy (3rd ed)

Director Briefings

- A Framework for Board Oversight of Enterprise Risk
- Board Oversight of Tax Risk—Questions for Directors to Ask
- Controlled Companies Briefing—Questions for Directors to Ask

- Diversity Briefing—Questions for Directors to Ask
- Guidance for Directors: Disclosure and Certification—What's at Stake
- Guidance for Managers: Disclosure and Certification—What's at Stake
- Long-term Performance Briefing—Questions for Directors to Ask
- Shareholder Engagement—Questions for Directors to Ask
- Sustainability: Environmental and Social Issues Briefing
—Questions for Directors to Ask

The Not-for-Profit Director Series

NFP 20 Questions Series

- 20 Questions Directors of Not-for-Profit Organizations Should Ask about Board Recruitment, Development and Assessment
- 20 Questions Directors of Not-for-Profit Organizations Should Ask about Fiduciary Duty
- 20 Questions Directors of Not-for-Profit Organizations Should Ask about Human Resources
- 20 Questions Directors of Not-for-Profit Organizations Should Ask about Risk
- 20 Questions Directors of Not-for-Profit Organizations Should Ask about Social Enterprise

Other Publications

- A Guide to Financial Statements of Not-For-Profit Organizations
—questions for directors to ask
- Accountants on Board—A guide to becoming a director of a not-for-profit organization
- Governance for Not-for-Profit Organizations: Questions for Directors to Ask
- Improved Annual Reporting by Not-for-Profit Organizations

About the Author

Elizabeth Watson, QC — Founder, WATSON

Elizabeth Watson has over 30 years experience as a lawyer and over 10 years advising boards, committees and CEO's from all sectors on governance and board recruitment issues. Liz works closely with the corporate governance community in Canada and is a sought after speaker and contributor on governance and recruitment issues.

Liz currently serves on the board of St. George's School and previously served as Chair of Choice School for Gifted Children and director of the Institute of Corporate Directors, the Forum for Women Entrepreneurs, the BC Cancer Foundation, Women in the Lead Inc. and as a member of the Canada's Top 40 Under 40 Advisory Board.

In 2012, Liz was named one of Canada's Most Powerful Women: Top 100 by WXN. She was chosen as one of the inaugural Top 100 Influential Women of British Columbia in 2010 and an Influential Woman in Business (Vancouver) in 2007. Liz holds an LL.B from the University of British Columbia and completed executive education in the areas of governance and finance at Harvard University and Ivey Business School respectively.



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