Nomination Committee: Overlooking the Obvious?

Cornel Germann

PhD student at the University of St. Gallen. His research focuses on behavioural aspects of Boards of Directors with a special emphasis on Board Committees, director selection, and strategic leadership.

What makes great Boards great? Firms – good and bad – respond with the adaption of rules and practices: equity involvement, regular meeting attendance, Board size, diversity, and independence. According to Yale and former Harvard professor Jeffrey A. Sonnenfeld[1], this is a fallacy that he calls the «inadequacy of conventional wisdom». For him the key to great Boards is not of «structural but of social nature. The most involved, diligent, value-adding Boards of Directors may or may not follow every recommendation in the good governance handbook». The human element is just as (if not more) important: respect and trust, cultural ability for open dissent, and responsiveness for sensemaking. Board composition is therefore a complex, ensnared system that cannot be pursued by «box ticking» exercises. It is rather a sound mix of formal roles and procedures and «sense and intuition» for the right choice of candidate.

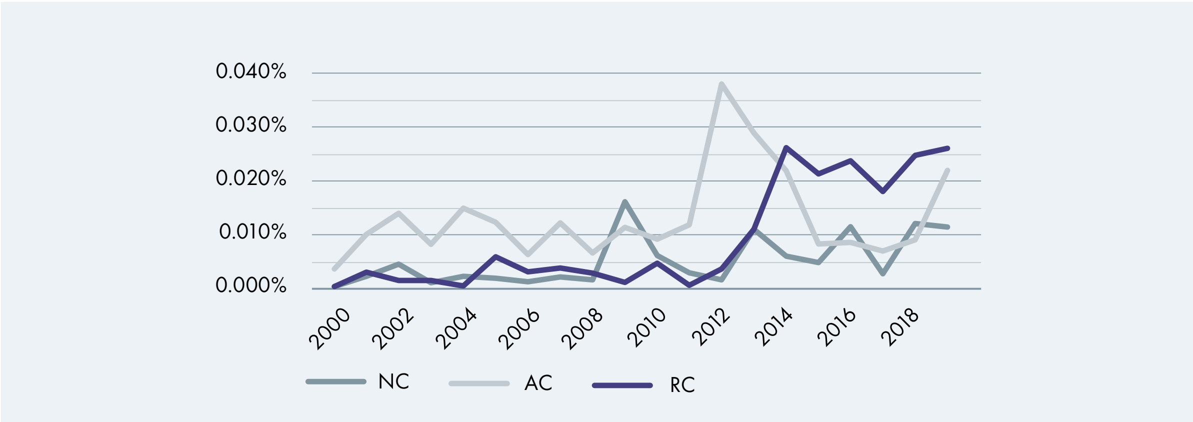
Board professionalism is in high demand now more than ever. Institutional investors, proxy advisors, NGOs, and several other stakeholders have become active and demand the bar for best practice requirements to be raised. For example, codified Glass Lewis is a broad skills matrix that examines the Director nominees. The Nomination Committee as the backbone of executive and board succession planning is required to follow the recommendations made by the Glass Lewis Policy Guidelines. The Chairman and the Chair of the Nomination Committee therefore take the bulk of responsibility for ensuring that a well-established and tailor-made succession process is in place.

Despite the Nomination Committees' increasing presence and their integration into various international and national governance codes (especially since the Cadbury Report 1992), their practices have been largely overlooked. An indicator for measuring and comparing corporate actions with the public's interest is salience. Salience is the proportion of related newspaper articles in proportion to the total number of articles published[2].

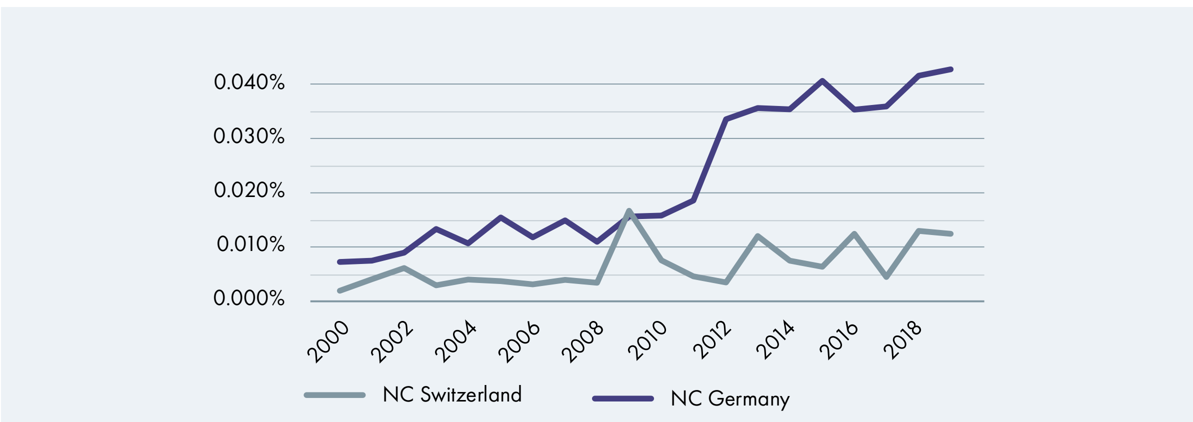
1 Jeffrey A. Sonnenfeld (2002): What Makes Great Boards Great

2 Factiva text search, www.factiva.com

Newspaper Coverage Switzerland



Newspaper Coverage Switzerland vs Germany



NC = Nomination Committee, AC = Audit Committee, RC = Remuneration Committee

As illustrated in the left graph, in the aftermath of accounting (financial crisis) and pay scandals (Minder Initiative, «say on pay»), the Swiss public and regulatory authorities were more concerned with the roles of the Audit Committee and the Remuneration Committee than with the role of the Nomination Committee. What Germany (right graph) has already experienced, partly because of the revision of the German Corporate Governance Code, will follow in other countries.

It is expected that for stakeholders (predominantly proxy advisors, institutional investors and NGOs) the Nomination Committee will become the core focus area within the governance sphere. Therefore, one wonders why – from the perspective of the regulators, academics and practitioners – Switzerland has not fared better in this respect in the past, neither in qualitative nor in quantitative terms.

Why is it important to improve corporate practices regarding the Board member selection process? In principle, the composition of the Board – speaking of the interaction of the Board as one entity – determines the future orientation of the firm. Yet, so far neither in Switzerland nor abroad, there is (1) a common denominator determining how the process should be carried out according to quantifiable best practice principles or (2) a means of comparability and evaluation amongst firms since only few people actively take part in shaping the selection process. It therefore often appears as if the Chairman / Chair of the Nomination Committee act as they see fit without having a concise formal policy in place that they need to follow. It is therefore time to build a basis. In the context of Swiss governance, the following settings should be addressed:

- **Hybrid board element:** Unlike in the US, Switzerland's hybrid governance approach is not CEO-driven. To date, studies measuring the influence of contextual factors, speaking of the management or shareholders, on the Nomination Committee and the Board are scarce and vague. Yes, the CEO shall take part in the Nomination Committee and get to know the candidate before the proposal is made by the general shareholder meeting. However, it should be a conscious decision; the manner of CEO influence depends on timing and complexity. The primary objective should still be supervision and not the promotion of management or stakeholder influence.

- **Network orientation:** Succession planning is highly network-driven and «one of the most critical issues [...] that is changing from one of cronyism and good-old-boy networks to one of selection based on expertise»[3]. Expertise is key. Today, Nomination Committee members still rely too much on their own network. «A favour for a favour» per se is not a bad thing but no longer meets today's expertise and professionalism requirements. After all, the Board of Directors is the final controlling organ at the top of the organisation which requires compiling a broad range of competences. Therefore, it is essential to recognize networks as «sociospatial constructions, not simply as connections or pipelines»[4].

- **Transparency through voluntary disclosure:** From an outside perspective, the work of the Nomination Committee resembles a large, opaque black box. It is entirely clear that Board content is subject to confidentiality and does not belong in the public domain. So far, however, the type of work the Nomination Committee pursues in detail is unclear. By hard law, the Board of Directors is not obliged to disclose any information on why a candidate is «a good fit». From a soft law perspective, however, it is expected (and in taking a good governance perspective warmly welcomed) that corporations disclose a candidate's fit to the profile and highlight the formal process decisive for the election of Board members. In a coherent manner, the corporate governance report would certainly be suitable for that purpose. For the firms, it may minimize the risk of a shareholder lawsuit for inadequate Board composition and / or help overcome that proxy advisors refuse a candidate because of no / too little information.

- **Stakeholder involvement:** The composition of the Board of Directors and executive succession are processes often carried out with the help of a partner's expertise: external consultants, headhunters, etc. On the one hand, external support is an indication that the Board is eager to have professional succession planning in place. On the other hand, it is also a risk that involves a tendency for a «tick the box» exercise. Such an exercise may lead to a simple «search grid practice» based on the requirement profile. It is therefore even more important for the Nomination Committee to keep track on (1) a conscious decision as to whether and when an expert should be called in and (2) determining whether the candidate «fits» the current Board dynamics and needs. Above all, conscious – and more importantly unconscious – dynamics are revealed in the individual Board of Directors' meetings, to which experts usually have no access to. Therefore, the involvement of external parties is no substitute for a thorough selection process but rather an «assisting service». In addition, the appointment of a candidate to the Board of Directors always leads to great interest in the media. The society, NGOs, politicians, and key business partners should thus – as far as possible – also be considered and adequately addressed in communication patterns.

3 O'Neal and Thomas (1995): Director networks/director selection: The Board's strategic role

4 Faulconbridge et al. (2009): The 'war for talent': The gate-keeper role of executive search firms in elite labor markets

A best-practice approach for the Nomination Committee entails effort and time, whereby – implemented accordingly – the positive effects outweigh. Beneficial factors include, for example, efficiency gains that improve capital strength, better ESG rankings that increase attractiveness for capital funds and investors, and the avoidance of scandals and public scrutiny on issues that may damage the company's reputation, such as «insider knowledge and insider trading». However, «living up to the formal standards is not enough. More attention should be paid to correct governance attitude and behaviour»[5]. More than ever, it is about «doing the right thing» and «doing the thing right» which requires constant effort and commitment on the part of the company and its individual members. Then in the end, the question is not «what» but rather «who makes Boards great».

5 van den Berghe and Levrau (2004): Evaluating Boards of Directors: What constitutes a good corporate board?