Institute for governance
of private and public organizations

Board members are independent but are they **legitimate** and **credible**?

Policy Paper No 10

2018

Toward Value-Creating Governance®

Institute for governance
of private and public organizations

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Legal Deposit – June 2018
National Library of Quebec
ISBN 978-2-924055-46-5 (Print version)
ISBN 978-2-924055-47-2 (Digital version)

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Includes bibliographical references
Printed in Quebec
Design by Karine Bellerive
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Board members are independent but are they **legitimate** and **credible**?

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Policy Paper N° 10

Prepared and written by

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Executive Chair, IGOPP

2018

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Message of the Executive Chair

For the 10th time since its inception, our Institute is taking a formal stand on a singularly important issue of governance. This latest policy paper focuses on the issue of board independence and its limitations. We put forth the notion that boards should focus more on their legitimacy and credibility. Already in 2008, when we published our first policy paper on the subject of board independence, IGOPP argued that independence was but a necessary condition of legitimacy and credibility.

For the purpose of defining our position on this issue, IGOPP created a working group of members of its board of directors. Thanks to their extensive experience on various types of boards, the group contributed to shaping this policy paper and the recommendations it contains.

The members of the working group, which was chaired by the undersigned, were:

- Mary-Ann Bell
- Isabelle Courville
- Paule Doré
- Stephen Jarislowsky
- Robert Greenhill
- Michel Magnan
- Claudine Mangen
- Andrew Molson
- Robert Parizeau
- Guylaine Saucier

I thank them warmly for their precious and insightful contributions to the process and the final result. At the end of the day, our whole board received, discussed and unanimously[1] approved this position of principle.

We trust that our recommendations will prove to be a significant contribution to a better quality of governance.

Yvan Allaire, PhD (MIT), FRSC
Executive Chair of the Board of Directors

1 Except for Louis Morisset who, as President of the Autorité des marchés, had to, and did, abstain from voting on this policy paper.

Executive Summary

That boards should be made up of a majority of independent members, that goal has been achieved in almost every type of organization. While this achievement did undoubtedly raise the quality of governance, it turned out that «independent boards» were not the cure-all medicine that some anticipated.

Already in 2008 in a policy paper on that topic, IGOPP predicted that the concept of directors' independence would not yield the expected results and would prove disappointing in many respects.

That policy paper suggested that the concepts of **legitimacy** and **credibility** were far superior to the concept of independence in driving the performance of organizations. For IGOPP, independence – a director's lack of any personal interests contrary to those of the company – was but a necessary condition for legitimacy.

Events since, in particular the financial crisis of 2008, have backed up the position taken by IGOPP at the time and have generated new legitimacy issues such as the diversity of boards, the representation on boards of stakeholders other than shareholders, the right, contingent upon a minimum holding period, to nominate candidates for the board, age and tenure limits for board membership.

As for board's credibility, the 2008 policy paper proposed that it hinged on "its experience and expertise relevant to the specific issues and challenges of the organization", on its in-depth knowledge "of the company's business model and its drivers of economic and social value" (Allaire, 2008). **For IGOPP, credibility also entails integrity and mutual trust between management and board members**. Therefore, this credibility was so important that it would be acceptable, and even necessary, to trade-off some independence if this was the price to pay for raising the board's credibility.

Since 2008

Profoundly shocked by the discomfiture of so many impeccably governed corporations during the financial crisis of 2008, companies, regulators and all savvy observers of governance had to admit that board independence and general management experience in industries with little in common with the firm to be governed were an insufficient basis for high-performance governance. Boards must also have a high level of expertise and experience about the specific issues and challenges faced by the company they were to govern. The changes in the world of governance since 2008 have validated the position taken by IGOPP back then, and shown that its stance was a prescient one.

However, some have noted that the quest for credibility may be difficult to reconcile with the requirement of board independence. Indeed, if a candidate is highly credible by virtue of a long association with the industry in which the company operates, it may be difficult for him or her to qualify as an independent according to the exacting *desiderata* now set for an immaculate independence.

IGOPP's position in 2018 offers some clarification and tackles some of the new issues which have arisen since 2008.

Thus this policy paper proposes a fundamental change in governance with respect to board evaluation, member selection and profile of expertise sought for the board.

Board evaluation

The evaluation of the board is the first pillar of board reform. IGOPP proposes a revised approach to the evaluation of board members focusing on their legitimacy and credibility.

Is the board **legitimate**? Do the process of board nomination and the manner of their election or appointment confer legitimacy unto board members?

Under current regulations and practices, all shareholders (but only shareholders) have the right to vote for the election of board members of public companies. However, significant shareholders who have held their shares for a given period of time may soon obtain rights to nominate candidate(s) for the board.

IGOPP believes that the goal of enhancing stakeholder representation on boards and expanding the board's legitimacy will become significant issues in the near future.

Is the board **credible**? Clearly, all, or nearly all, boards meet the regulatory requirement of a majority of independent members, but are boards generally credible?

IGOPP proposes that board members be evaluated for their specific knowledge of, and experience with, the type of business or organization they are asked to govern. Do members understand in depth its business model, its drivers of value creation, the risks, issues and challenges in this particular industry, its comparative performance, etc.?

A board of directors is only credible to the extent that a significant number of its members are able to interact knowledgeably with management on components of performance and the multiple factors that have a dynamic influence on that performance. This type of exchange calls for a board's deep and systemic understanding of the company's business model.

Selection of new members

The chair of the board and its governance committee should devise a selection grid which corresponds to the current requirements for board membership. Thus, more than half of the members must be independent and a degree of diversity is becoming an essential requirement of the board make-up. Ideally, the board should look for new members who are independent, add to the board's diversity, *and are credible* within the meaning given to this term in this policy paper.

Where a candidate has qualifications which would otherwise make her or him attractive for the board but lacks the requisite experience/knowledge to qualify as a credible director upon appointment/election, it is crucial to ensure, in advance, that the person has the time, the training and the intellectual rigour to acquire a sound level of credibility within a reasonable time; it is essential that a customized development program be set up to foster that new member's credibility.

Profile of experience and expertise

The conventional approach consists of drawing up a list of the different types of professional expertise which it is thought desirable to assemble on the board (accounting, finance, human resources, risk management, IT management, etc.). Prior experience in senior management and as a member of other boards of directors becomes a nearly universal prerequisite.

This policy paper strongly suggests that, actually, the drawing up of this profile should begin by identifying industries with characteristics that closely tract those of the industry in which the target company operates: such as capital intensity, time horizon of investments, industrial vs. consumer markets, international scope of competititon, key success factors, generic strategies. The reason for this is obvious. As recruiting board members from the same industry will often result in candidates who are not independent for some reason or another, the search should be broadened to industries which are similar in important features.

Executives with experience in such industries will more quickly master the essential aspects of a company operating in a "similar" industry. This recommendation will help reconcile the regulatory need for "independence" and the important quest for "credibility".

That recommendation applies equally if and when a board is looking to select some new member with, say, an expertise in finance. The selection process should stress that this experience must have been acquired in an industry with comparable characteristics (as defined above) to that of the target company. There is very little transferable expertise, whether in financial management, human resources, risks or information technology, between the retail business, a resources company, a financial institution or a firm in the aerospace industry.

Conclusion

Our policy paper from 2008 (Allaire, 2008) remains fully relevant to this day. In fact, the events that have occurred since 2008 support and strengthen the recommendations we formulated in 2008. While we were a voice in the desert at the time, our observations and conclusions have now become inescapable, are supported by empirical studies, and have been taken up by all serious observers of the current dilemmas of governance.

This revision of our 2008 policy paper adds some clarifications, juggles with some new issues that have become inescapable, and reminds all boards of directors that:

While it is legitimacy that gives the board the right and authority to impose its will on management, only through its credibility will a board play fully its value-creation role for all stakeholders of an organization (Allaire, 2008).

Introduction

Once, in a bygone era, boards of directors of public companies were made up largely of corporate officers with some “affiliated” members (basically lawyers and others serving the company) and a sprinkling of “external” members. The image below shows the virtually all-male board of IBM in 1970, a highly successful company, a model of enlightened management, and the most admired U.S. corporation at the time.

Seated, left to right: Amory Houghton, Jr., Cyrus R. Vance, William H. Moore, Paul L. Davies, Emanuel R. Piore, Patricia R. Harris, Franck T. Cary, T. Vincent Learson, Thomas J. Watson, Jr., Georges L.Hinman, Bruce Bromley.

Standing, left to right: Maersk McKinney Moller, Gilbert E. Jones, William McChesney Martin, Jr., Grayson Kirk, Louis H. LaMorte, Albert L. Williams, G. Keith Funston, John Clifford Folger, Nicolas de B. Katzenbach, John M. Fox n’est pas présent.

Until recently, Japanese companies had succeeded in dominating broad segments of industries, which were formerly the fiefdoms of U.S. companies, by relying on boards of directors essentially composed of corporate officers.

Did this form of governance have a deleterious effect on company performance? It is impossible answer this question with empirical data as board composition and corporate governance generally received very little attention in academic circles at the time. However, some investors did claim that these types of boards were a bit too “fraternal”, too complacent, and too lax in their oversight of management.

Leveraged Buyout Funds

Corporate governance began to change during the 1980s as funds (known as leveraged buyout funds (LBO)) challenged these arrangements. LBO funds claimed that the then-current form of governance failed to maximize value for the shareholders and should be changed by the privatization of targeted companies, a truly "revolutionary" concept. The period 1980-1989 was indeed characterized in the U.S. by a singularly large number of hostile takeovers and the privatization of public companies. Then, board members were replaced by *non-independent representatives* of the new owners – the LBO funds.

This "revolution", which was to some degree successful, eventually abated but it had a sustained influence on the governance of public companies and the compensation of their executives. Clearly, boards drew the lesson from this LBO phase that they were at risk of an hostile attack if they did not enhance their supervision of, and their independence from, management.

General Motors

Then, in the early 90s, *General Motors* (GM) (the largest U.S. corporation at the time) was assailed by financial problems and enmeshed in an embarassing imbroglio brought about by GM's acquisition of EDS. As a result, Ross Perot, the founder of EDS, became GM's largest shareholder and was duly elected to GM's board. This caustic, voluble and uncontrollable entrepreneur soon began to publicly denigrate GM's management and board, calling GM's board members "pet rocks", useless in his view.

Eventually GM had no choice but to buy back all of Perot's shares at a premium price to get him off the board. However, this traumatic episode combined with a deteriorating financial situation led GM to undertake in 1992 a major overhaul of its management and governance. As a result, GM published, in January 1994, a set of 28 principles of governance, quite revolutionary at the time: for example, the division of the roles of CEO and chair of the board and the concept of "lead director", if the CEO is also the chair of the board; "in camera" sessions with the external members alone; the selection of new members by the board and not the CEO; board members given access to senior officers, and so forth.

CalPERS

Concurrently, during the years 1990-2000, institutional funds became, collectively, the majority shareholders of most public U.S. corporations. CalPERS, the large retirement fund of the employees of the state of California, seized upon GM's principles and called upon the 200 companies in which CalPERS held a substantial number of shares to implement these governance principles. Indeed, the GM principles were rapidly adopted by numerous companies. Thus, over the course of this decade, boards came to be made up of a majority of independent members.

Sarbanes-Oxley and company

The hope that boards made up of a majority of independent members would protect the company and its shareholders against mismanagement, fraud and financial turpitude died with the fiascos named Enron, WorldCom, Global Crossing, Tyco and numerous others in 2001-2003.

Many lessons were learned from these scandals. Stock exchanges, regulators and, eventually, the U.S. government through the adoption of Sarbanes-Oxley (SOX) placed the blame for these fiascos squarely on the weak oversight of management by insufficiently "independent" board members. Henceforth, a majority of members of the boards and all the members of the board's statutory committees – the nomination, compensation and audit committees – would have to be independent, *according to stricter rules to qualify as independent*.

Thus, at the time Sarbanes-Oxley was adopted, it was estimated that 64% of the companies on the S&P 1500 had some board members who were classified as independent but who, in reality, had relationships with the CEO that could jeopardize their independence. These board members were dubbed by some researchers as "gray directors".

SOX and company raised the bar for members of a board to qualify as "independent". The aim was to produce boards whose members (a majority of them anyway) would be of "immaculate" independence. As a result, the number of companies with at least one "gray" director fell to 33% in 2016 (Hwang, 2018).

Despite the fact that the empirical studies were not really successful in establishing a stable and statistically robust relationship between "the board's independence" and the company's performance[2], it seemed that this independence was desirable in principle and could only enhance the quality of governance. It is remarkable that people believed at the time that the board's strengthened independence could directly and statistically influence a phenomenon such as the company's performance, which is the result, on the one hand, of decisions and actions taken over time and, on the other hand, of contingencies and vagaries outside management's control.

2 Among the many studies on this topic, we might mention Duchin, Matsusaka and Ozbas, 2010; Beltratti and Stultz, 2012; Wintoki, Linck and Netter, 2012; Crespí-Cladera and Pascual-Fuster, 2014; Volonté, 2015. Canadian studies tend to reach the same conclusion (for exemple, Gupta, Kennedy and Weaver, 2009; Adjaoud, Zeghal and Andaleeb, 2007). However, Bozec, Dia and Bozec (2010) find some positive statistical relationships betwee a score of governance and some measue of «productivity».

In any event, and for argument's sake, statistical studies are not sensitive enough, nor are they designed, to capture the contribution which independent directors can make, or may have made, by their blocking of initiatives that, in their view, were too hazardous, or by their changing/rejecting ill-advised proposals of management.

While the enhanced independence of directors may certainly have led to improved oversight of management, the concept quickly took on the allure of a panacea, of a philosopher's stone.

But this entire edifice of governance was once again shaken to its foundations by the financial crisis in 2008. Clearly, the impeccable independence of board members, the pillar of corporate governance and management oversight, did not weather well the "perfect storm" of 2008.

IGOPP Policy Paper (2008)

In September 2008, on the eve of the financial crisis, IGOPP published a policy paper on the meaning and limitations of board independence. IGOPP argued that the concept, undoubtedly useful for a time, had been pushed too far and brought about issues which in some ways were more damaging to governance than the old system of fraternal boards (Allaire, 2008).

Drawing on an earlier paper by Professors Allaire and Firsirotu (2003), IGOPP proposed that board members should be assessed for their *legitimacy and credibility*. It suggested that independence – a director's lack of personal interests contrary to those of the company – was but *a necessary condition for legitimacy*. Assuming candidates for board membership who qualify as independent, then the process of their selection, nomination and election must be such as to confer upon them a high degree of perceived legitimacy. That is, the legitimacy of a board is based on the fact that the stakeholders of the organization played a significant role in the selection of board members.

The IGOPP policy paper also stressed the pressing necessity for board members to be *credible* (Allaire, 2008). The credibility of a board is assessed by the "*collective experience and expertise of board members about the very specific issues and challenges of the organization*" (p. 14), and by the board's thorough knowledge of *the company's business model and its drivers of economic and social value* (p. 14).

IGOPP maintained that a board's credibility is so critical that it would be legitimate, and even necessary, to suspend the requirement of independence for some members if this was the price to pay for achieving a higher level of credibility on the board. For, indeed, a board deficient in credibility would tend to focus on monitoring and compliance issues and to skimp on its strategic, value-creating, role.

Furthermore, the policy paper pointed out the large number of controlled corporations in Canada (in 2008, some 22% of the 253 companies on the TSX had a shareholder with more than 30% of the votes). IGOPP expressed the opinion that this fact called for some adjustments in Canadian governance rules, too often copied from U.S. regulations designed for widely-held corporations. The phenomenon of publicly-listed corporations with a controlling shareholder was fairly rare in the U.S. (at least at that time).

For IGOPP, it seemed anomalous that the regulations of the Canadian Securities Administrators prohibited significant and credible shareholders (who were not members of management) to sit on board committees. The policy paper stated that "*the significant shareholders who play an active role in the governance of a company (but not in its management) also bring a high degree of legitimacy (and credibility) to the board. This type of legitimacy deserves full recognition. These shareholders should be represented on the board and on standing committees in proportion to their economic interests in the company*" (Allaire, 2008, p. 20).

Since 2008

The financial catastrophe of 2008 traumatized the world of governance. While the terms "legitimacy and credibility" did not acquire currency, what they stood for soon became unavoidable. From that point on, everyone, or nearly everyone, stressed the limitations of "independent" directors and called for board members with skills and experience, *not of a general nature, but specific to the issues and challenges of the precise company they are called upon to govern*. (Kroll, Walters and Wright, 2008; McDonald, Westphal and Graebner, 2008; Faleye, Hoitash and Hoitash, 2011; Balsmeier, Fleming and Manso, 2016, and others).

Experienced, real-world, observers of corporate governance suddenly began to sing the praise of "specific competence", and of "understanding the company's business model" (for example, William, 2013; Bailey and Koller, 2014; and Lorsch et al., 2012, *The Future of Governance*, by a group of experienced directors and professors from Harvard Business School).

Having interviewed 78 board members of large U.S. companies, Lorsch (2012) reported that they, unanimously or nearly so, expressed the opinion that boards must significantly enhance their skills, and lamented "*the huge deficits in expertise and understanding of the business*". The more complex a business is, the more important it is that the board can count on directors who are well versed in the arcane aspects of its operations, although it may be at the price of their sacrosanct independence.

Lorsch (2012) concludes thus: "*It is difficult, if not impossible, to find directors who possess deep knowledge of a company's process, products, and industries who can also be considered independent*."

Similarly, William George (2013), an experienced director who sat on the boards of numerous U.S. corporations, commented: "*Information asymmetry is often at the root of this challenge. When directors are truly independent of the companies they serve, they generally lack the wealth of knowledge about the industry or business that their senior-executive counterparts have*."

Thus, developments in the world of corporate governance since 2008 support the policy position IGOPP took at that time and make our policy stance rather prescient.

Board legitimacy and credibility in 2018

Board legitimacy in 2018

It should be kept in mind that legitimacy is an essential quality for the governance of any organization or institution. Weakened legitimacy is usually a precursor of radical change. Directors' legitimacy hinges on the processes put in place for their selection, nomination or election. Their status as "independent" should remain **a necessary but not sufficient condition, of their legitimacy**.

On the other hand, we note that, in 2017, some 25% of the companies on the TSX had one shareholder (or related shareholders) with more than 30% of the votes[3]. When such significant shareholders *are not members of the management* but participate in the company's governance, they should also be seen, in our view, **as legitimate directors** and authorized to sit on all the board committees. Recently, the Canadian Securities Administrators (CSA) undertook a broad consultation on this topic which, in theory, could lead to an amended position on their part so that significant shareholders (not members of management) may henceforth sit *on standing committees of the board*. However, this change of mind seems unlikely.

But, recent developments raise new issues about the concept of independence and its relationship to the legitimacy of boards of directors.

1. Nomination of board candidates by significant shareholders;

2. Representation on the board of stakeholders other than shareholders;

3. Board renewal, maximum age, and loss of independent status beyond a certain number of years on the board.

1. Nomination of board candidates by significant shareholders

Recently, shareholder proposals were put forth to compel companies to allow important shareholders to submit nominees for the board. These nominees would rank *pari passu* with management's own nominees for voting purposes. A typical proposal of this nature would run as follows: a group of shareholders (limited to 20 shareholders) who hold collectively **at least 3%** of the shares (or votes?) and held these shares **for at least three years** may submit nominees for a maximum of 20% of the seats on the board.

IGOPP has raised several practical objections to this recent initiative.[4] Nevertheless, a proposal of this nature has already been accepted (or voted in) by some 80% of the companies on the S&P 500. While adoption is much slower in Canada, already the large chartered banks have yielded to pressure while the influentiale Canadian Coalition for Good Governance is advocating in favor of such an initiative.

3 Source: TSX data compiled by IGOPP, April 2017.

4 See IGOPP's policy paper: *Who should pick board members?* (Allaire and Dauphin, 2015).

Will the candidates nominated by a group of shareholders be perceived as truly independent of the shareholders who proposed them for the board? Even if these candidates were not, strictly speaking, independent, they are however legitimate because they were nominated by significant and long-standing shareholders? Whether independent or not, if shareholders elect them with a majority vote, is this not the best indication of their legitimacy?

Since this new development calls for a minimum holding period of shares to acquire the right to legitimately submit candidates for election to the board, would it not be consistent to also require a holding period (say, one year) for a shareholder to acquire *the legitimate right to vote*[5]?

Board members elected would then acquire much greater legitimacy than the current process provides with an election in which *share swappers, tourist shareholders, and transient speculators* participate in the electoral process on the same footing as *long-term shareholders*. If holding period conveys a right to put forth board nominees, a right that is not available to short-term holders, the same logic would, it seems, sustain our proposal to subject voting right to a minimal holding period. It will not happen soon but the idea is catching on, as some perceptive observers view this initiative as an alternative means of achieving some of the benefits of multiple-voting shares.

2. Representation on the board of stakeholders other than shareholders

The practice of appointing representatives of other stakeholders, usually workers, to the board, is well established in Germany, France and the Scandinavian countries. The government of the United Kingdom is juggling with legislative amendments to encourage the formal representation of stakeholders other than shareholders on the board.

In the United Kingdom, as in Canada, corporate law (and the interpretation thereof by the courts) is clear: directors in exercising their powers and discharging their duties shall act honestly and in good faith with a view to the best interests of the corporation (Article 121 (a) of the Canada Business Corporations Act (CBCA)). The Supreme Court of Canada has interpreted this clause in a way that gives all stakeholders an equal standing.

However, the court has not called for any change to the CBCA (Canadian Business Corporation Act), nor have governments acted to introduce in the CBCA the concept of representation by stakeholders other than shareholders.

Board representation for other stakeholders raises issues of independence and legitimacy. How, for example, can other stakeholders be persuaded that the workers' representatives is totally independent of the workers' association and will stand in solidarity with board decisions when they may have a negative impact on workers? How should representatives of a stakeholder group be chosen so that they are *legitimate both for this group of stakeholders as well as for other stakeholders?*

5 IGOPP did propose, in its second policy position, a one-year holding period to acquire the right to vote shares in publicly traded ompanies. "*Corporate Citizenship and the right to vote*" (Allaire, 2006).

While a broad representation of stakeholders on the board is attractive in principle, in practice, it raises thorny issues which cannot be dealt with in a cavalier fashion. And the experience of other countries is not always relevant for, or transferable to, the North American context.

3. Board renewal, maximum age, and loss of independent status beyond a certain number of years on the board

Regulators, proxy advisors (notably Institutional Shareholder Services (ISS)) and other governance enforcers often claim that members who have been sitting on a board for more than a given number of years might not be independent anymore and should not be considered as such.

This claim hangs on the argument that friendship is bound to have developed between such long-tenured board members and management (even though management may have totally changed during this period!). Thus, long-standing directors, it is claimed, risk becoming complacent, unwilling to challenge the status quo, and disinclined to question the strategies and decisions of management.

We have found no studies to support these hypotheses. Only one study, among the large body of articles of the Social Science Research Network (SSRN), deals with this issue (Dou, Sahgal and Zhang, 2015). Their study concludes that companies that have directors with more than 15 years of experience on the board: "[…] *have lower CEO pay, higher CEO turnover-performance sensitivity, and a smaller likelihood of intentionally misreporting earnings. These firms also restrict the expansion of resources under the CEO's control as they are less likely to make acquisitions, while the acquisitions that are made are of higher quality. Efforts to impose term limits may, therefore, be misguided.*"

In fact, using our terminology, directors will often require a considerable amount of time to become **credible**, if he/she was not so from the start. It is surprising that so-called governance experts should propose rules which are contrary to a corporation's interest and performance based on no solid empirical facts.

A member with a long tenure on the board does not *ipso facto* become a credible director, but it is possible that the knowledge he/she acquired over the years may substantially enhance his/her credibility. The declaration by some form of governance enforcers that such a director is non-independent should not lead to his or her exclusion from the board for as long as a majority of the board members qualify as independent in accordance with the standards of the Canadian Securities Administrators.

Although it has not been the subject of any regulations, many companies, for obvious reasons, adopt an age limit for the members of their board. Here again, the unspoken (or unspeakable) assumption is that an advanced age always, and without exception, reduces a person's physical vigour and mental energy and impedes him or her in carrying out the responsibilities of a director. The age demarcation is variable and has shifted significantly to the right over time (from 65 to 70, 72 and 75 years of age). Again, such policies are based on no solid evidence.

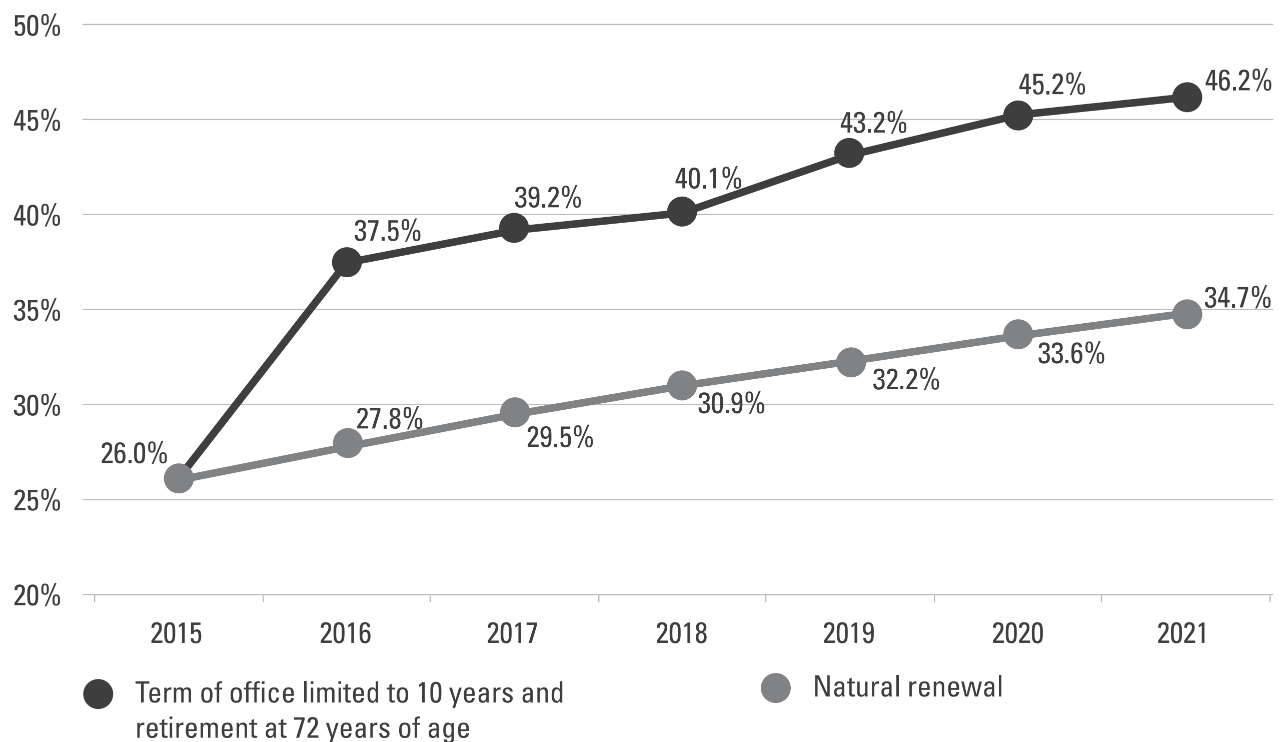
But, it may well be that policies to impose limits of duration or age of board members have been merely the least disturbing and least emotionally charged process to "refresh" board membership and increase diversity. Such policies avoid the animosity and the cost in human relationships that easily results from a systematic evaluation of board members with resulting invitations to some members to leave the board.

No doubt that policies on term limits for board members and/or maximal age would accelerate the rate of diversity on boards. It is clear that the current low replacement rate for board members (about 7% per year) imposes a slow rate of increase in the number of women on boards of directors. As Figure 1 shows, the participation of women on the boards of large Canadian corporations, *even with a policy of appointing a woman for every two available positions*, will grow slowly over time (gray line).

However, with a policy of appointing a woman for every two vacancies combined with a retirement age of 72 and a term limit of 10 years (dark line in Figure 1), the proportion of women on the boards of large corporations jumps to about 40% in three years.

Figure 1

Simulation of board diversity
based on certain replacement policies



Source: Allaire and Dauphin, 2015.

However, though supportive of increased diversity of boards, IGOPP does not endorse the boosting of replacement rate through age and tenure policies. As credibility is a condition *sine qua non* of a board's effectiveness, all board members, young and old, long-tenured or recent arrivals, should be evaluated *for their added value to the board's credibility*.

Such an evaluation, which could well result in a significantly faster replacement rate for some years, would mean asking some members to leave the board; but that is a much superior means of "refreshing" the board. *Of course, this approach requires a good measure of courage on the part of board chairs and members of the governance committees*.

Board credibility in 2018

A board's credibility is measured not only by its in-depth knowledge of the company's industry and its markets, of its business model, and its value-creation drivers, but also by the integrity and the trustworthiness of its board members. The more complex the company, the more difficult it is for a director to be credible, as was shown in the financial sector during the years leading up to the crisis of 2008.

Take the example of the tragic fate of Lehman Brothers, which declared bankruptcy on September 15, 2008, the triggering event of the financial crisis. Lehman's board of directors, which was typical for the time, was made up of independent people, many of whom were ex-CEOs of large corporations (IBM, GlaxoSmithKline, Haliburton, Telemundo Group, Sotheby's).

The board made its decisions on the basis of the members' experience, which had little relevance for the business of Lehman, an investment bank and a large trading operation in complex financial products.

The report of the examiner appointed to adjudicate on the responsibility of Lehman's board of directors (Jenner & Block, 2017) is instructive:

For the board meeting of March 20th, 2007 at which a fateful decision was made about larger financial commitment by Lehman to the sub-prime mortgage market, the people responsible for preparing a presentation for the president of Lehman exchanged e-mails conveying his expectations: "Board is not sophisticated around subprime market- Joe [the president of Lehman] doesn't want too much detail. He wants to candidly talk about the risks to Lehman but be optimistic and constructive – talk about the opportunities that this market creates and how we are uniquely positioned to take advantage of them" (Jenner & Block, 2017, p.90).

Although Lehman's management did not provide the Board with all available information concerning the risks faced by the firm in 2007 and early 2008, that fact is not surprising given the Board's limited role in overseeing the firm's risk management, and the extraordinarily detailed information available to management. (Jenner & Block, 2017, p. 185).

This example provides a crucial demonstration of the point we are making: a board made up of independent members with impressive biographies is not ipso facto credible. The sad fact that many boards do not have credibility explains the low added value of corporate governance in too many organizations.

A board's credibility is assessed by the answers to the following questions: does the management feel that the board understands in depth their strategic issues, the complexity and ramification of proposed decisions? Do the members of the management team feel that discussions with the board are productive and stimulating, bring out new viewpoints and add value to the decision-making process? Does management trust the board and the board management?

If, upon joining the board, new members do not have a high level of credibility, have they committed to invest the necessary time, do they have the education and intellectual wherewithal to become credible within a reasonable period of time…and to maintain that credibility?

In our day and age, board members will not become, nor remain, credible if they do not master the immense reservoir of information available on the Internet to fashion their own independent sources of intelligence.

A board's credibility is the cornerstone (and maybe even the long sought-after philosopher's stone!) of effective governance. Thus, **the search for, training and retention of, credible board members has become the dominant issue and inescapable challenge for governance in the 21st century.**

Recommendations

To the Canadian Securities Administrators

It seems unlikely that the Canadian Securities Administrators will amend their regulations to recognize that it is legitimate for significant shareholders, who are not members of management, to sit on committees of the board (audit, compensation, nomination). This surprising position is at odds with the abundant empirical evidence that such shareholders as board members act more swiftly and vigorously to fire executives and moderate their compensation, when appropriate.

Nevertheless, IGOPP suggests that the Canadian Securities Administrators reflect on concepts of legitimacy and credibility as these are board attributes far superior to "independence" in fostering high corporate performance.

IGOPP's policy position is that board members' independence is a necessary condition of legitimacy, but does not ensure it. Thus, for a board member lacking in integrity, his or her independence becomes meaningless. Furthermore, "*it is through its legitimacy, not its independence, that the board acquires the right and authority to impose its will on management*" (Allaire, 2008).

To boards of directors

This policy paper proposes a new process for selecting and nominating board members that focuses on three essential points: the evaluation of the board, the selection of new members, and the targeted profile of experience and expertise for board members.

1. Evaluation of the board

The evaluation of the board is the first, and essential, pillar of a governance transformation.

This evaluation must answer the following questions: *is the board* ***legitimate***? Do the process of board nomination and the manner of their election or appointment confer legitimacy unto board members? Will the shareholders always remain the sole stakeholder capable of conferring some degree of legitimacy on the members of the board of publicly listed corporation? Do minority shareholders, where applicable, have the right to directly elect some members of the board? Will shareholders who have held their shares for a certain time period acquire thus superior rights to nominate or elect board members than is granted to transient and newly arrived shareholders?

Under current regulations and practices, all shareholders (but only shareholders) have the right to vote for the election of board members of public companies. However, significant shareholders who have held their shares for a given period of time may soon obtain rights to nominate candidate(s) for the board.

IGOPP believes that the goal of enhancing stakeholder representation on boards and expanding the board's legitimacy will become significant issues in the near future. Even within the current restrictive legal framework, legitimacy issues arising from the processes for nominating and electing board members must be addressed forthwith; as well, it is appropriate to elucidate the reasons for variations in elective support received by different members of the board.

*Is the board **credible**?*

Clearly, all, or nearly all, boards meet the regulatory requirement of a majority of independent members, but are boards generally credible, that is more than half of its members are credible?

IGOPP proposes that board members be evaluated for their specific knowledge of, and experience with, the type of business or organization they are asked to govern. Do members understand in depth its business model, its drivers of value creation, the risks, issues and challenges in this particular industry, its comparative performance, etc.? Which members of the board can explain the measures of its economic performance as well as the factors driving this performance? *It is important that most (all) board members exhibit the level of economic and financial knowledge required to understand the financial complexity and business specifics of the organization they are called upon to govern*.

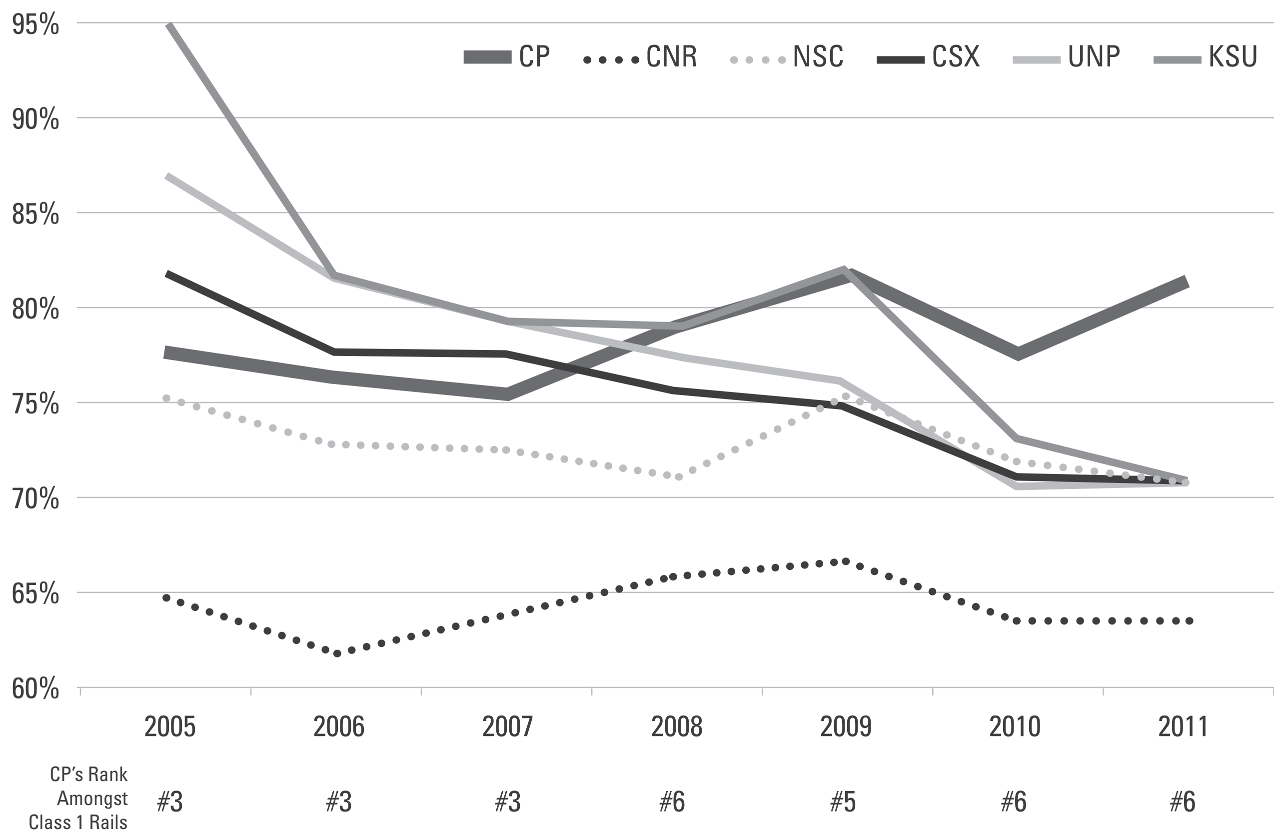
An example: Canadian Pacific

This company, which was the subject of a brutal attack by an activist fund in 2012, provides a textbook example for our purposes. The members of the board at the time were all formally independent (except for the CEO) and had extensive experience in the following industries: banks, energy, wines and spirits, steel, maritime transport, the public sector, and the practice of law. The absence of any member with experience in the railway transportation sector is notable.

Despite the fact that several members had been sitting on the board for 5 to 10 years, it seems, *either*, that the board accepted management's justifications for the significant deterioration in CP's position – as shown in Figure 2 which tracks the operating ratio of various firms in the sector – *or, that the board was not even informed of this deterioration*.

Figure 2

Operating Ratio by Year
Railway companies, 2005-2011



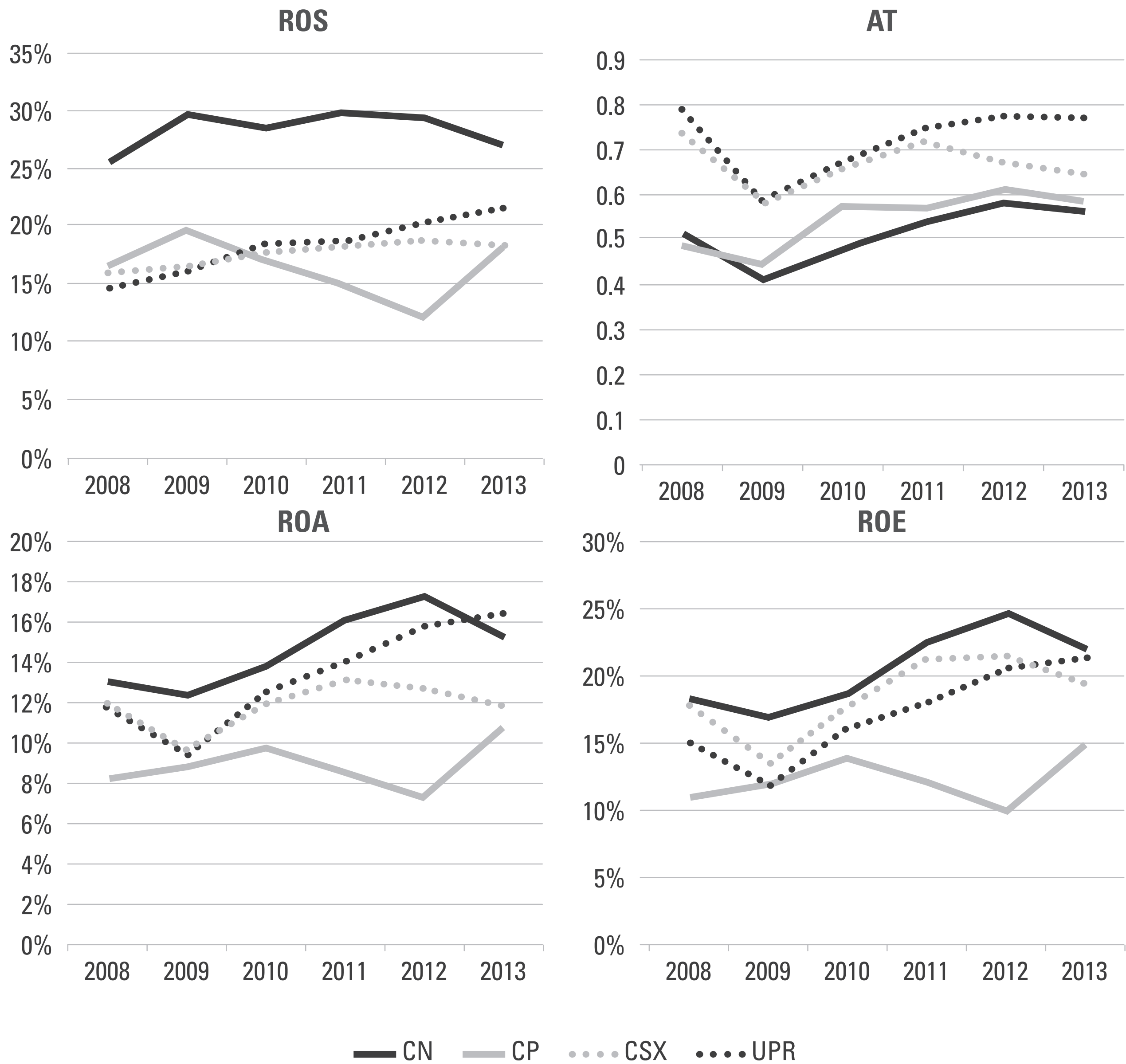
Source: Allaire and Dauphin, 2016.

Would (some? or all?) board members at the time have been able to explain the dynamic factors underlying the change in the performance ratios from 2008 to 2012, as shown in Figure 3?

What accounts for the much higher figures for return on sales (ROS) at CN in comparison to CP, and the sharp improvement in CP's performance from 2013 under a new management? While other railway companies compensate for their (relatively) low ROS with better asset turnover (AT), CP did not achieve that. Why?

Figure 3

Selection of Performance Indicators
Railway companies, 2008-2013



Source: Allaire and Dauphin, 2016.

As a result, the return on assets (ROA), a fundamental measure of economic performance, which captures the combination of ROS and AT (ROA=ROS x AT), shows CP's underperformance from 2008 to 2012. And what are the factors linking ROA to the return on shareholders' equity (ROE)? Why does a gap of some 10% in ROA between CN and CP in 2012 become a gap of some 15% for ROE?

A board of directors is only credible to the extent that a significant number of its members are able to interact knowledgeably with management on components of performance and the multiple factors that have a dynamic influence on that performance. This type of exchange calls for a board's deep and systemic understanding of the company's business model.

2. Selection of new members

The chair of the board and governance committee members should devise a selection grid which corresponds to the current requirements for board membership. Thus, more than half of the members must be independent and a degree of diversity is becoming an essential requirement of the board make-up. Ideally, the board should look for new members who are *independent*, add to the board's *diversity*, and are *credible* within the meaning given to this term in this policy paper.

However, the board may have to make some trade-offs and compromises between these three desirable characteristics. Thus, as regulations allow nearly half of the members not to be independent, candidates with a high level of credibility but who are not formally independent may be selected to strengthen the board's credibility.

There are two caveats however: 1. The candidate's lack of independence must not be the result of a business relationship with the management or company but, rather, brought about as a result of subordinate considerations, such as, for example, that it has been less than 3 (or 5) years since the person left or ceased holding a job in the industry, etc.; 2. Unfortunately and inexplicably, such a qualified candidate will not be authorized under current regulations to sit on important committees of the board.

Where a candidate has qualifications which would otherwise make her or him attractive for the board but lacks the requisite experience/knowledge to qualify as a credible director upon appointment/election, it is crucial to ensure, in advance, that the person has the time, the training and the intellectual rigour to acquire a sound level of credibility within a reasonable time; it is essential that a customized development program be set up to foster that new member's credibility.

3. Profile of experience and expertise

The conventional approach consists of drawing up a list of the different types of professional expertise which it is thought desirable to assemble on the board (accounting, finance, human resources, risk management, IT management, etc.). Prior experience in senior management and as a member of other boards of directors becomes a nearly universal prerequisite.

This policy paper strongly suggests that such a profile should begin by identifying industries with characteristics that closely tract those of the industry in which the target company operates: such as capital intensity, time horizon of investments, industrial vs. consumer markets, international scope of competititon, key success factors, generic strategies. The reason for this is obvious. As recruiting board members from the same industry will often result in candidates who are not independent for some reason or another, the search should be broadened to industries which are similar in important features.

Executives with experience in such industries will more quickly master the essential aspects of a company operating in a “similar” industry. This recommendation will help reconcile the regulatory need for “independence” and the important quest for “credibility”.

That recommendation applies equally if and when a board is looking to select some new member with, say, an expertise in finance. The selection process should stress that this experience must have been acquired in an industry with comparable characteristics (as defined above) to that of the target company. There is very little transferable expertise, whether in financial management, human resources, risks or information technology, between the retail business, a mining company, a bank or a firm in the aerospace industry.

Conclusions

Our policy paper from 2008 (Allaire, 2008) remains fully relevant to this day. In fact, the events that have occurred since 2008 support and strengthen the recommendations we formulated in 2008. While we were a voice in the desert at the time, our observations and conclusions have now become inescapable, are supported by empirical studies, and have been taken up by all serious observers of the current dilemmas of governance.

This revision of our 2008 policy paper adds some clarifications, juggles with some new issues that have become inescapable, and reminds all boards of directors that:

While it is legitimacy that gives the board the right and authority to impose its will on management, only through its credibility will a board play fully its value-creation role for all stakeholders of an organization (Allaire, 2008).

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Created in 2005 by two academic institutions (HEC Montréal and Concordia University – The John Molson School of Business), the Stephen Jarislowsky Foundation and the Autorité des marchés financiers, the Institute for governance (IGOPP) has become a centre for excellence about governance of public and private organizations. Through research, training programs, policy papers and participation in public debates, IGOPP has become a key reference on all issues of governance in the private and public sectors.

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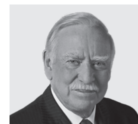

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