Comments on OSC Form 58 – 101F1 (Corporate Governance Disclosure)

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Qualifications/Background of the Commenter

Over the past 17 years, I have worked with more than 130 Boards of Directors in Canada, the United States and around the world, primarily public companies. I began my career in Canada where, in 1996/7 I became a consultant to the Board of Directors of The Bank of Montreal under Matt Barrett's chairmanship. During this time, among other things, BMO became the first board in North America to implement an individual director evaluation process. I was transferred to New York in 2000 as a partner in Mercer Delta (a boutique consulting firm owned by Marsh & McLennan), subsequently led the Hay Group's Board Effectiveness Practice and started my own consulting firm, Board Advisor LLC, in 2009 to continue working with boards all over the world.

My focus is on creating and sustaining truly great Boards of Directors – boards that are a genuine asset to the companies they oversee and to those who own/invest in those companies.

My last book, *Great Companies Deserve Great Boards* (Palgrave Macmillan, 2011) was named **Governance Book of the Year** in the United States by *Directors & Boards* magazine and made the *Globe & Mail Business Best Sellers List* (ranking #1 on the *Globe* list for 4 weeks in 2011). From 2007-2010, I was a regular columnist on board issues *for Bloomberg BusinessWeek.com* and recently began contributing a regular column to *LISTED* (the TSX magazine) called *The Boardroom.*

Among other things, for the past four years, I have served as Lead Faculty for the Malaysian Directors' Academy; Malaysia being the first predominantly Muslim country to introduce targets for gender diversity in executive roles and the boardroom. I have also served as faculty at the Canadian Institute of Corporate Directors' Director Education Program at McGill for nearly 10 years and as faculty for the Conference Board of Canada's Directors' College in Niagara on the Lake for 15 years.

In terms of education, I have an HBA from the Ivey Business School (University of Western Ontario), an LLB (Cum Laude) from the University of Western Ontario and an MBA (Beta Gamma Sigma) from the Haskayne Business School (University of Calgary). I was called to the Bars of both Alberta and British Columbia but relinquished membership in both when I ceased being an attorney 18 years ago.

I am a dual citizen of Canada and the United States.

Comments

Defining Success

The OSC's overarching goal in any governance regulation it adopts should and must always be the advancement of better corporate governance in Canada – better practices that make for better boards and better corporate oversight. The advancement of women and the promotion of diversity are both worthy goals – but the key to the OSC's initiative is to achieve these goals while at the same time enhancing governance. Those who would declare success if the OSC's initiative results in an increased proportion of women on Canadian boards over the next few years miss the point. Success can and should only be declared if the proportion of women on Canadian boards has increased ***and*** it becomes commonly felt in the Canadian business community that the changes have made boards better.

A good analogy is the adoption of executive sessions. When these were first required in the United States by the 2003 governance rules of the NYSE and the Nasdaq, boards balked at them – and so did CEOs. Indignant directors argued, "What a waste of time! There's nothing I need to say in an executive session that I wouldn't say in front of the CEO!" Ten years later, most boards in the U.S., Canada and around the world agree that executive sessions are one of the most valuable components of any board meeting. So it should be with diversity initiatives – three, five or even ten years down the road, boards should generally agree that they had a positive impact. Only then, in my view, can success be declared.

Once we define success in this way, it becomes apparent that it can be achieved if – and only if – women who are recruited to Canadian boards have the relevant backgrounds and experience enabling them to ask the meaningful questions and offer insightful comments which earn them genuine respect at the board table. Having seen many women directors do just that over the past 17 years and become true board leaders, I know that this is possible and achievable. However, it is highly dependent on the relevance of the director's background.

For example, if a director candidate (female or male) has no P&L experience, no experience in the industry in which the company operates and/or limited strategic or financial expertise, these shortcomings cannot be overcome by a director training program or a comprehensive board orientation. Not every board member needs ***all*** of these attributes. But those without one or more of them may lack the breadth to become a real thought-leader in board debates. Consequently, he/she is more likely to be grudgingly re-nominated rather than viewed as a significant contributor.

That said, I nonetheless believe there is an abundant candidate pool of high quality board talent – frankly, of both men and women – that has been untapped for a very long time in both Canada and the United States. The OSC's initiative may well serve as a hinge to unlock it, if the proposed regulations are slightly beefed up and if director search models are redesigned.

Beefing Up "Comply or Explain" with Flexible Targets

In 1994, the Dey Report introduced a series of corporate governance guidelines considered, at the time, both important and controversial. They were adopted by the TSX in a "comply or explain" mode similar to the way the Cadbury Report (an analogous initiative in the UK) was adopted in Britain in 1992. Five years later, a 1999 report entitled "Five Years to the Dey" revealed that Canadian companies had done a lot more "explaining" than "complying" when it came to adopting the Dey Guidelines in that timeframe.

In 2003, in the wake of the Enron scandal, the major US stock exchanges finally introduced governance regulations. Many of these were similar to the guidelines advocated by Dey - with one big difference: Failure to comply meant de-listing from the NYSE or the Nasdaq. Not surprisingly, within 2 years nearly every board in the US (and most of those in Canada) had "got with the program".

"Comply or explain" is a gentler approach likely to be better received in Canada. But without at least a suggested target, I fear a similar experience to Dey and would urge the OSC to consider the use of flexible targets along these lines in creating its new policy to beef it up:

Regulation: ***All Chairs of TSX Non-Venture Listed Boards shall be required to establish and disclose a target range for the number of women directors they aim to have on their boards by 2017.***

Commentary: ***A minimum of 3 women directors may be an appropriate target for most Canadian boards. Nonetheless, targets may and should vary by industry and other factors. For example, in mining/metals (an industry which traditionally has had a more limited pool of female executives) a reasonable target may be 1-2 women directors, whereas in retail (an industry which traditionally has a more expansive female executive talent pool and female customer demographic), a target of 4-5 women at the board table may be more appropriate.***

This recommendation offers even greater flexibility than the UK diversity regulations by enabling boards to come to their own decisions on targets while acknowledging the practical differences in industry talent pools. The "regulation" vs "commentary" approach is similar to what the NYSE adopted in their 2003 governance guidelines; while only the Regulation itself was enforceable, the "moral suasion" of the commentary was significant and most boards factored such commentary into their decisions on compliance and disclosure.

If you require boards to disclose diversity targets and suggest what "reasonable targets" might look like, there is little need to require further disclosure of a corporate policy regarding the representation of women on boards. The board will either hit those targets, or they won't. If they don't, they'll have to explain to their shareholders why they didn't.

Risks of Creating a Two-Tier Board Dynamic

Targets or quotas for board composition carry with them two inherent risks:

a) That individuals who lack the expertise/backgrounds that the board really needs will nonetheless be recruited as directors in order to meet the target/quota;

b) That directors who help the board to meet its target/quota but are not actually very effective as board members will nonetheless continue to be re-nominated.

If this occurs, it creates an unhealthy "two-tier" board dynamic whereby those in the "target group" are held to a different/lower standard than other board members.

In the United States, I have observed similar dynamics even without the imposition of quotas. For example, in a recent director evaluation process I was involved in, a Hispanic board member received some very negative feedback about his performance. Having served on the board for several years, he still appeared unable to grasp some of the fundamentals of the company's business. His questions in board meetings often lacked relevance and took the board into tangential issues, eating up a considerable amount of board time while creating little value. None of the other directors felt he was capable of chairing any of the board's four committees, meaning that his utility as a member of a 9-person board was limited. Nonetheless, the Nominating/Governance Committee struggled mightily with the issue of his re-nomination because he provided diversity to the board and brought some knowledge of the Hispanic market, penetration of which was a key element of the company's growth strategy.

To use another example from Central America, a family-controlled company which allocates one-third of its board seats to family members routinely wrestles with the fact that two family members who serve on the board lack the financial and operational business backgrounds other directors provide and are therefore unable to contribute to board discussions and decision-making at the same level.

Overcoming these thorny issues depends almost entirely on the quality of the director talent pool within the target/quota group. In the first instance, for example, the board's ability to readily recruit another Hispanic director with strong credentials and perhaps an industry background would have made their re-nomination choice an obvious one. In the second, access to family members who provided broader business expertise than those currently serving would have enabled a similar decision.

Surfacing that talent – not just initially but on an ongoing basis so that new board members are readily available when needed – is critical to ensuring that board effectiveness is enhanced rather than detracted by diversity initiatives.

Shortcomings in Typical Director Recruitment Practices

In the United States, and I suspect in Canada as well, we have witnessed notable shortcomings in the way director search is typically conducted:

a) **Highly qualified candidates with no prior public company board experience are often overlooked or consciously "passed by" in the director recruitment process.**

> This issue has become a significant bottleneck in the pipeline of boardroom talent throughout North America. It impacts both men and women who have outstanding qualifications for board service but have not previously served as an independent director on a public company board.
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> One executive recruiter who specializes in board search told me in confidence: "When I'm charging my clients $100,000 a head (the going rate for a director in the Fortune 500) I want a reference who can say, "I've been on a board with that person and here's what they're like as a director. And I'm talking about a public company board - not a non-profit."
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> In a way, that's understandable. On the other hand, however, this approach can serve to dramatically limit the board talent pool - and appears to be doing so: Spencer Stuart's Canadian Board Index indicates that of those directors recruited to the boards of the largest 100 Canadian companies, 70% have already served on one or more public company boards. Identical numbers were found in Spencer Stuart Board Index of the Fortune 500. This factor may actually be one of the reasons both US and Canadian boards have been so slow to increase their proportion of women directors.
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> Boards that are open to "first timers", however, are able to tap into a talent pool that offers a broader range of experience and typically includes sitting CEOs, CFOs and other active (vs retired) executives – primarily because sitting executives are typically limited by their own boards to serving on only one outside board. As such, most have no prior company board experience as an independent director.
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> Recruiting a new director without prior board experience may require the Nominating and Governance Committee to make a more significant investment in training. To this end, director education programs such as those offered by the Institute of Corporate Directors and the Conference Board of Canada can be helpful. Another successful approach has been to pair up the new director with an incumbent board member for his/her first year so that the new recruit can ask questions on an ongoing basis about governance vs management-level issues, significant concerns the board has raised in the past, etc.

b) **Director recruitment typically involves a retainer fee structure that is not performance-based.**

Strange as it may seem in a boardroom world dominated by discussions of "pay for performance", many executive recruiters engaged in director search operate on a retainer. This model typically means that the recruiter is paid a flat fee whether they find a successful director candidate or not. It emphasizes and rewards "the sale" – getting the client to engage the search firm - rather than the delivery of high caliber director candidates.

The experience of one of my clients in the U.S. is not untypical. Here's how their Chairman described it to me: "We hired a search firm and paid them $100,000 as a retainer. The candidate list they came up with was, frankly, pretty poor. I got the sense these were people they owed favors to and wanted to place as board members. We sent the list back and demanded that they "go back to the drawing board". The second list was a bit better but compared with the names we had generated from the networks of our own directors and executive team, they paled in comparison. We recruited two directors – both of whom were people we'd identified before the search firm came onto the scene. Yet we still paid the recruiter a fee of $100,000. I felt that no value was delivered for our money."

In fairness, there are many instances where search consultants have done an outstanding job of finding new board members and earned every dime of their fees. But the experience outlined above is by no means a "one of", either. For this reason, I recently encouraged three of my US board clients to adopt a performance-based fee structure where the bulk of the search consultant's fees were earned based on the caliber of director candidates surfaced and ultimately recruited to the board. All three found this to be a more satisfactory model.

I provide these observations to offer a counterpoint to some of the comments made at the October 16, 2013 roundtable on this topic. Rigorous approaches to director search will become one of the most critical underpinnings for the success of this entire initiative by the OSC. However, achieving this may require some notable departures from the approach taken to director recruitment today.

The proposal that boards disclose their "**director identification and selection process**", however, seems meaningless. I'd urge the OSC to consider two alternatives and choose one of them:

Alternative A – Take it Out: Ultimately, the proof is in the pudding – boards are either recruiting high quality female directors or they're not. However they get there, quite frankly, is up to them. As proposed, this disclosure requirement is likely to result in little more than a wordsmithing exercise.

Alternative B - Beef it Up: In Commentary to this regulation, indicate that Nominating/Governance Committees should disclose not only if they have used a search firm but also the fee structure used (retainer or performance-based), the amount of the fee, the credentials the board was seeking in a new director, the number of female candidates included in the search, the number of candidates included in the search with no prior public company board experience, the number of candidates generated by the search firm vs the board's own network vs shareholder nomination, etc.

Director Term Limits

Boards are notoriously weak when it comes to director performance management. They may fire their CEO, tell the CEO to fire members of the executive team, turn over their auditors, compensation and search consultants – but when it comes to dealing with a director who is clearly out of his/her depth in the boardroom, asks “off the wall” questions or, as Chair Wetston noted in the roundtable meeting of October 16, 2013, is clearly past his/her “best before date”, there is reluctance to step up to the issue.

PWC’s 2013 Board Survey of 934 public company directors found than 35% felt a fellow board member should be replaced. That’s a big number. The top three reasons given for this view were: (i) Diminished performance because of age; (ii) Lack of requisite expertise; and (iii) Poor preparation for meetings.

The charters of most Nominating and Governance Committees typically describe the committee’s role in this way: To identify, recruit and re-nominate directors. But these are the mechanics by which the committee fulfills its responsibilities. In my mind, the real job of a Nominating/Governance Committee is to put the best possible directors they can find around the board table. Held up to this standard, I suspect many would fall short; the PWC data reinforces that view. For far too long, the norm has prevailed that a director will continue to be re-nominated until he/she hits the retirement age or term limit. This is a norm that serves neither boards nor shareholders well.

Director term limits and retirement ages are nothing new. They have been used as vehicles to stimulate board renewal for well over a decade. Although 82% of boards surveyed by the OSC had no director term limit policy, I suspect many have a director retirement age. Spencer Stuart’s 2012 Canadian Board Index indicates that 57% of the largest 100 Canadian companies have mandatory retirement policies (age and/or term limits) for their board members, but does not provide a breakdown between the two.

Spencer Stuart’s US data, however, reveals that 73% of the Fortune 500 have adopted mandatory retirement ages for their directors, while only 4% have term limits. (In the US, terms limits tend to be used by non-profit boards while public company boards typically use retirement ages, although some boards use both.) Given that three quarters of Fortune 500 boards have retirement policies designed to stimulate board turnover, yet no more progress has been made on gender diversity in US boardrooms than we have seen in Canada, I question whether term limits are really the answer. In my view, the “comply or explain with flexible targets” approach outlined on page 3 is likely to have far more impact.

That said, if the OSC is adamant about term limits, I’d offer some further commentary on this issue:

I agree with commentators at the October 16, 2013 roundtable meeting who believe that a director’s independence can be compromised the longer he/she serves on a board. But I have also witnessed the contrary on more than one occasion: At one of my clients, for example, the Chairman - who has served as a board member for 15 years - is able to contradict the CEO more effectively than anyone else in the boardroom because of his depth of knowledge of the company and its history.

Indeed, there can be significant value in the institutional memory that longer serving board members can provide. At the same time, this consideration needs to be balanced with the value of fresh boardroom thinking offered by new directors. Both are important. For this reason, I would urge the OSC to consider a balanced rather than a blanket approach on this issue, such as:

Regulation:* *Boards must disclose whether they have adopted a policy to stimulate board renewal – be that a director retirement age, director term limits, etc.- providing details of the policy and the rationale for it.

Commentary:* *Boards which have adopted a term limit or retirement age policy may choose to set and disclose a discretionary target for a proportion of board members to be excluded from this policy. For example, having a policy that no more than 2 directors will have served for more than 10 years or that no more than one director over the age of 72 will be re-nominated may be more appropriate than a blanket policy.

Very little discussion occurred on the topic of individual director evaluation at the October 16, 2013 roundtable when the subject of board renewal was aired. Individual director evaluations can actually serve as a more productive vehicle than either age or term limits when it comes director re-nomination decisions. However, this is ***only*** true when the evaluation is conducted in a way that ensures complete candor and produces constructive feedback. Until rigorous processes of this nature become more widespread in Canada, this is probably not a realistic "substitute" for other measures. Nonetheless, it would be remiss to comment on board renewal policies without some reference to this practice.

The OSC's Initiative in the North American Context

Many other countries have introduced initiatives to foster gender diversity in the boardroom. Yet, because of the similarities in business culture, board structure and the business network between Canada and the US, the Canadian initiative is likely to capture American attention more than any other.

Having chosen to address this issue, it is critically important that the OSC's initiative be a successful one. If this initiative produces more proxy boilerplate with minimal impact on board composition, it will have failed. If it results in the addition of female directors who are grudgingly re-nominated for "optics reasons" rather than for their contributions as board members, it will have failed. But if, instead, it opens the door to an array board talent that results in Canadian boards and executive teams honestly concluding: "Our board is better today because of the women directors we added" it will have achieved real success. Whatever happens, the Canadian experience will be held up for comment time and again in the U.S. and will serve to establish a North American precedent.

I applaud the OSC and the Ontario Teachers' Pension Fund for stepping up to this important issue and putting it onto the North American governance agenda in a meaningful way. I hope that my comments and perspectives are helpful. If you would like to contact me regarding any of them, I can be reached at Beverly.behan@boardadvisor.net .