MSCI ESG THOUGHT LEADERS COUNCIL

FROM MSCI ESG RESEARCH LLC

BOARD COMPOSITION AND REFRESHMENT | JULY 2016

INTRODUCTION TO THE MSCI ESG THOUGHT LEADERS COUNCIL

The goal of the MSCI ESG Research Thought Leaders Council is to maintain our leading edge in research methodology by regularly seeking feedback and opinions from external experts in key industries and relevant ESG issue areas. The MSCI ESG Research Thought Leaders Council consists of a series of about three to four panels annually, with three to seven members on each panel. We aim to assemble international experts with recognized leadership and expertise on the topic area related to the panel.

The ninth council on Board Composition and Refreshment, the second in a series of panels on corporate governance themes, was held on July 6, 2016. Panel members were asked to review MSCI ESG Research's proprietary GovernanceMetrics Ratings methodology, as well as specific company and thematic reports before participating in the official panel call with MSCI ESG Research. The following key takeaways and discussion points represent a summary of the discussions and do not represent a transcript.

COUNCIL MEMBERS*

Michelle Edkins
Managing Director,
Global Head
of Investment
Stewardship,
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Deborah Gilshan
Head of Sustainable
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Christianna Wood
Chair of the Board
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KEY TALKING POINTS

1. KEY CHARACTERISTICS ASSOCIATED WITH HIGH PERFORMING BOARDS

- **Preparedness and Participation:** High performing boards fundamentally exhibit consistent attendance and active, constructive participation by all directors; a high level of preparedness is critical.
- **Diversity of Ideas:** Cross fertilization of ideas is important. External input and feedback, such as via outside speakers, can help tease this out.
- **Relevant Expertise:** It should be clear why a particular individual is on the board – their expertise and contributions to the board as a whole should be clear and acknowledged by all.
- **Succession planning:** A formal self-evaluation process is important, and succession planning, including that of non-executive directors, should always be on the agenda.
- **Effective Leadership:** Effective leadership is important, and requires an even higher level of commitment, as does involvement in certain committees. The CEO and the Chairman must have a strong relationship but one that is not too comfortable, which allows the Chairman to hold the CEO to account. This is a critical relationship when it comes to board effectiveness. Boards must be focused on strategy, and be able to say no to the CEO when strategic concerns demand it.
- **Strong Outcomes:** Actual outcomes are the best external indicators of board strength or weakness. Boards should be held to multi-year outcomes, with 3-5 year outcomes at a minimum.
- **Reasonable Compensation:** For compensation committees, clear, robust performance indicators are critical, but even more important is the board's willingness and ability to say no to CEOs whose pay demands may be unrealistic.

2. KEY CHARACTERISTICS ASSOCIATED WITH BOARD WEAKNESS

- **Overly Powerful CEOs:** Generally speaking, autocratic CEOs tend to have weaker boards.
- **Lack of Direct Incentives:** In most markets, directors who hold no shares also suggest a weaker, less vested and committed board.
- **Overboarding:** Individuals should not sit on too many boards, including non-profit boards, which are often not counted but may, in fact, represent an even greater degree of time commitment than public company boards.

3. EVALUATING BOARD EFFECTIVENESS

- **Nuances of Related Party Transactions:** Some related party transactions reported are probably not material and should not be assessed in isolation. Related party transactions should be a point of questioning, but are not necessarily indicative of a weak board.
- **Geographic Context:** When evaluating market specific differences it is important to determine whether a particular market's Corporate Governance standards are rules or principles based. Comply or explain works well in some markets, but probably not in the US or Japan.
- **Board Evaluation Disclosures:** While internal board evaluations are not shared externally, the frequency and process of such evaluations can and should be disclosed. Board evaluations are not yet widely undertaken in many markets.
- **Investor Perspective:** Board evaluations don't generally include input from investors, but this might be something that boards should consider in the future, to gain a better understanding of the sentiment of investors. In this context, Chairman letters describing the work of the board, and in particular specific committees, can be very helpful in conveying a clearer sense of the board's overall effectiveness. Also, boards should try to understand the signals behind voting results and respond appropriately.

- **Nomination Process Disclosure:** Board reporting should describe the nominating process and demonstrate its effectiveness. Typical considerations should include individual skills and experience; fit with current board; overall board needs.
- **Recruitment:** Search consultants are probably only used about 30% of the time, but that's not a bad thing, some of the best candidates come from other, less formal networks.
- **Investor Nominees:** Many investors do NOT wish to become director search consultancies, and relatively few individuals want to join a new board as designated shareholder representatives. While investors can make excellent board members, such instances can be atypical.

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ABOUT MSCI

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