

# Board Paper

## The Nomination Committee: Follower or Leader

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**Nomination committees have a critical role to play in maximising board effectiveness, succession planning and managing contingencies**

Strong committees are a vital part of making boards more effective. Over the past decade or so, as the workload of boards have increased and their decision-making come under greater scrutiny, committees have played an important role in overseeing specific areas of responsibility, developing recommendations for consideration by the full board, and reinforcing the independent supervision of management.

The audit committee has been at the forefront of reform, subject to its own best practice enquiry, led by Sir Robert Smith, which reported in 2003. Remuneration committees have also been constantly in the spotlight as they seek to devise pay packages that meet the demands of both executive managers and shareholders.

Against this background, boards must guard against viewing the nomination committees as the ‘poor relation’ of the various board committees. Sir Derek Higgs, in his 2003 review of the effectiveness of non-executive directors, argued that the nomination committee is “the least developed of the board’s committees, usually meeting irregularly and often without a clear understanding of the extent of its role in the appointment process.” He also found that many nomination committees met with directors present who were not committee members, making the committee indistinct from the board as a whole.

Finally, Sir Derek reported finding a high level of informality surrounding the process of appointing non-executive directors, with almost half of the non-executive directors surveyed for his review recruited to their role through personal contacts or friendships – only four per cent had had a formal interview, and one per cent had obtained their job through answering an advertisement.

Although the nomination process has been greatly professionalised in the six years since Sir Derek reported, it remains the case that nomination committees typically meet less often than their audit and remuneration counterparts, and their work is described only briefly in the annual report.

This state of affairs, however, disguises the fact that nomination committees have a critical role to play in maximising board effectiveness, succession planning and managing contingencies. Getting the right, best qualified people to serve on the board is at the heart of good governance, and the nomination committee is central to putting that principle into practice.

### ■ The Combined Code

The Combined Code recommends that boards adopt a formal, rigorous and transparent procedure for the appointment of both executive and non-executive directors, as well as the chairman.

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The Code goes on to stress that appointments to the board should be made on merit against objective criteria and that the board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board.

In practice, the responsibility for this falls on the nomination committee which is required to lead the process for board appointments and make recommendations to the full board. The nomination committee should make its terms of reference available for public scrutiny, with key elements typically including the following:

- Proposing to the board the responsibilities of non-executive directors including membership and chairmanship of board committees;
- Ensuring that there is a satisfactory, formal process for the selection of non-executive directors;
- Proposing to the board any new board appointments, whether of executive or non executive directors;
- Ensuring there is good succession planning at board level, whether of executive or non executive directors;
- Reviewing the effectiveness of directors; and
- Nominating suitable people for the most senior executive positions, including that of chief executive.

The committee makes recommendations to the board which either approves them or, stating its reasons for not doing so, asks the committee to reconsider them.

In addition, the Code recommends that a separate section of the annual report describes the work of the nomination committee, including the process it has used in relation to board appointments. An explanation should be given if neither an external search consultancy nor open

advertising has been used in the appointment of a chairman or non-executive director.

### ■ **The Role of the Nomination Committee**

Whether by accident or design, the Code gave remuneration committees three memorable words around which to focus their aspirations and activities, namely to “attract, retain and motivate.”

Neither the audit committee nor the nomination committee fell on such good fortune, but in considering the role of the latter we would like to suggest that “recruit, utilise, refresh” might bring a similar focus to its work.

### ■ **Recruit**

Few chairman have the opportunity to build their board from scratch, but as and when it is necessary to recruit new directors, it is an essential part of the committee’s work to ensure that the approach to recruitment, the benchmarking process used to evaluate both internal and external candidates, and the final recommendations made to the board are both appropriate and transparent.

### ■ **Utilise**

The nomination committee is expected to review the balance of skills, knowledge and experience on the board, and in light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.

This process requires the committee to understand the current effectiveness of individual directors (including members of the nomination committee themselves), the committees and the board as a whole. This can be a delicate area because the chairman and often the SID will also venture opinions of their own, and the nomination committee must walk a fine line between paying heed to their views while also meeting their responsibility to provide the full board with an independent recommendation.

**The committee's obligation to prepare a description of the role to be filled and the capabilities required relies on assessing the board's existing strengths and weaknesses**

Similarly, the committee's obligation to prepare a description of the role to be filled and the capabilities required relies on assessing the board's existing strengths and weaknesses. This assessment may reveal a lack of resource or capabilities that needs to be addressed, or may show that the existing talent on the board is not being optimally deployed. Are the right directors serving on the right committees? Is there a professional development programme that allows directors to update their skills and knowledge? These are the kinds of questions that a strong nomination committee will be asking as it seeks to gauge the board's current effectiveness and suggest ways to improve it.

■ **Refresh**

The Code asks the committee to satisfy itself that plans are in place for an orderly succession of appointments to the board and to senior management. The volatile nature of today's markets, and the rapid and unexpected swings in companies' fortunes, means that these plans need to be kept under almost constant review.

■ **Composition**

Unlike the audit and remuneration committees, which for FTSE 350 companies should be composed of at least three independent non-executive directors, there is no minimum size requirement for the nomination committee, though a majority of members are expected to be independent.

Similarly, the Code recommends that the board chairman should not chair either the audit or remuneration committees but may chair the nomination committee, though not when it is dealing with the appointment of a new chairman. Given its vital role, it is not clear why the Code offers no minimum size recommendations for the nomination committee, and boards must take care to ensure that it is never under-resourced.

■ **Chairmanship**

When Derek Higgs first published his review of the effectiveness of non-executive directors in 2003, he suggested that it would be in breach of good governance for the chairman of the board to chair any of the board's committees. Perhaps none of his recommendations elicited as fierce and active opposition as this one proposal.

Board chairmen argued strongly that they could not be held accountable for the performance of the board if they did not, at the very least, lead the nomination committee which was responsible for the selection, monitoring, and development of its members. In response, the Combined Code was subsequently amended to allow the chairman of the board to chair the nomination committee, albeit they should stand aside if their own succession is under discussion.

■ **Enhancing the effectiveness of the nomination committee**

Thanks to the governance reforms of the past nearly 20 years, audit and remuneration committees are widely seen to have steadily improved their professionalism and effectiveness.

But it remains an open question whether nomination committees have developed at the same rate. The nomination committee's responsibility, namely to ensure an orderly succession for appointments to the board and senior management, is central to the smooth running of the business, a point increasingly recognised in the investment community. At the very least, shareholders understand that a nomination committee that merely reacts to events runs the risk of allowing a leadership vacuum to develop that erodes shareholder value.

Furthermore, ineffective succession planning can have a significant impact on the work of the remuneration committee. Sizeable remuneration packages are frequently justified on the basis that the executive in question cannot be allowed

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to leave, an argument that should not need to be made at companies with management strength in depth.

There are two possible reasons why nomination committees can underperform: timetable and chairmanship.

Both the audit and the remuneration committees, by the nature of their work, are forced to work to strict timetables during the year. This has the benefit of imposing a discipline on their deliberations. The nomination committee, by contrast, is merely called upon to comment in the Annual Report on the progress it has made in relation to board appointments. There is no requirement to comment on the extent and effectiveness of succession planning, a point that the current review of the Combined Code should perhaps address.

In addition, board performance evaluation is arguably too important to be left to a one-off, set-piece annual event and should be subject to continuous review. The regular meetings of the nomination committee could be structured to include a discussion of the effectiveness of individual directors, both executive and non-executive, as well as the performance of the board and its committees. The nomination committee should also have a clear remit to ensure that a programme for continuous improvement, training and succession planning is in place.

The second possible cause of underperformance is that the nomination committee is the only one of the major board committees that, under the Code, may be led by the chairman of the board. Company chairmen are busy people with any number of competing demands on their time. We stress that the issue here is not one of individual competence; it is axiomatic that anyone chosen to chair the board must also have the skills and experience to chair the nomination committee. Nor is there a question of seeking to distance the chair from the work of the committee. Indeed many of the items under discussion – the performance of individual directors, the

board and its committees, and the skills and experience sought in new appointments – are central to the chairman's role.

The issue is one of operational effectiveness, and it is here that the senior independent director or one of the other independent directors, with fewer demands on their time, may be better in taking the chair. Inevitably extremely close cooperation with the chair of the board is essential. He/she may well wish to be a committee member.

It is arguable that the company chairman is at their most effective if they neither chair nor serve on any of the subsidiary committees, but rather add value in ensuring that every committee works subject to the appropriate checks and balances when brought before the full board.

Ultimately, one size can never fit all; the chairmanship and composition of the nomination committee should be an issue for individual boards to decide for themselves. The idea, however, that the nomination committee be led by someone other than the chairman is at least worthy of consideration.

#### ■ Conclusion

It is essential that nomination committees see their role as being proactive, rather than reactive, and as having a decisive impact on the smooth running of the business over the long term. Failure to recognise these central principles will lead to shareholders paying increasing attention to the work of nomination committees, and a possible tightening of governance best practice guidelines in this area.

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