EY
Building a better working world

Ernst & Young LLP
1 More London Place
London
SE1 2AF

Tel: + 44 20 7951 2000
Fax: + 44 20 7951 1345
ey.com

Catherine Woods
Financial Reporting Council
125 London Wall
London EC2Y 5AS

Friday 29 January 2016

Ref: EY

Direct line: 020 7951 5485

Email: ahobbs@uk.ey.com

Dear Catherine

EY Response to UK Board Succession Planning Discussion Paper

We believe that the work of the nomination committee is important for the long-term success of a company, but this committee does not appear to receive the same level of scrutiny and interest as other board committees. Therefore, we welcome your publication *Board Succession Planning, October 2015* ("the Discussion Paper") which helps to put this committee - specifically in terms of succession planning - under the spotlight.

Our review of 2014 FTSE 350 annual reports and accounts, *Annual Reporting in 2014: reflections on the past, direction for the future, September 2015,* found that succession planning is reported by many boards as simply 'an area for future consideration' following a board evaluation. Indeed, we also understand from speaking with investors that many companies appear to be on the back foot, responding to succession issues as and when they arise. It is no surprise then that directors routinely tell us that succession is one of the most difficult board issues. We investigated this topic with The Investment Association and published *Board effectiveness – continuing the journey, April 2015.* There are common threads between the findings of both of our publications and your Discussion Paper.

Clearly there is scope for improvement in succession planning. Launching this Discussion Paper and drawing attention to what best practice succession planning looks like, should go some way towards improving matters. To this end our responses to your questions are attached.

For the avoidance of doubt our responses are not confidential, and if in the meantime you have any questions please contact me using the details above.

Yours sincerely

A Hobbs

Andrew Hobbs
Partner
Corporate Governance & Public Policy

Ernst & Young LLP
United Kingdom

Appendix

Q1. By what practical methods can the development of business strategy and company culture be linked to succession planning?

Succession planning should be linked to strategy, not the other way round. It is a means primarily for sustaining the optimal composition of a board and its committees for the realisation of the company's strategy, and a revision or replacement of that strategy if/when required. It is also important to plan succession in light of the culture a board is trying to create, and the gaps it is seeking to close (i.e., values, behaviours and sense of purpose) in order for the new culture to evolve successfully.

An effective succession plan helps to ensure that the skills, experience and expertise represented at board level remain relevant for the business, regardless of any planned or unplanned changes to the membership of that board.

Practical methods for linking a succession plan to a company's strategy include:

- Develop specific search and selection criteria that match the skills, experience and expertise required by the board to deliver the company's strategy.
- Compare those criteria against the medium and long-term strategy and adjust accordingly, if the requirements expected of the candidate vary between the medium and long-term.
- Review and update that plan periodically to anticipate potential changes in the company's circumstances (e.g., markets or financing) where a board director might need to be replaced by someone altogether different.
- Provide briefings and updates to the search agency to ensure they are attuned to the company's circumstances and any changes (actual and potential) to the succession plan.

Practical methods for linking a succession plan to a company's culture include:

- Develop detailed job specifications - including the company's expectations in terms of values (plus behaviours and attitudes) of its board members and other employees.
- Use these specifications in psychometric testing and 360 assessments of potential candidates for board positions, to gauge the degree of alignment/misalignment between the candidate's values etc and those of the company including diversity of thought.
- Publish the succession plan - showing how people are recruited, rewarded, retained and promoted - to help communicate the culture of the company and accordingly attract candidates who share the same values.
- Apply the "9 box grid" to help identify talent and manage succession effectively (link to template provided by the Chartered Institute of Personnel & Development)
- Provide coaching and support post recruitment, to help sustain the individual's alignment with the corporate values.

In our report *Board effectiveness – continuing the journey, April 2015* we articulate that succession planning is improved if the board has a clear understanding of what an "ideal board"' might look like. The board can then create a matrix of the ideal board and begin the search for potential candidates up to three years prior to their appointment.

Q2. How best can the link between strategic planning and effective succession planning be reported?

The optimum approach would start with a clear explanation of the strategy together with an outline of the skills, experience and expertise of the incumbent board members. This should cover a range of variables including diversity of thought, level of challenge and background, rather than just a list of previous positions held by each member.

Companies could then map these variables against the medium and long term strategy. This would help to identify current and potential gaps in terms of what is required of the board to deliver the strategy. This could also include the business model (e.g., how people are engaged to develop tangible value). The succession plan would in effect become the means to close any gaps, and it could be reported as such.

If there are no gaps to fill at the present time, the nomination committee could report on its approach towards succession planning. It could explain how it keeps track of when directors are due to rotate off the board, thereby allowing enough time for due processes to be undertaken to ensure new directors of the right calibre are appointed.

The effectiveness of the linkage between strategic planning and succession planning can be demonstrated by reporting on the qualities (e.g., skills and experience) sought from potential candidates for the board, and the qualities held by recent appointees. This shows the relevance of the appointee's qualities to the business and its strategy, and accordingly it would prove that the succession plan was a success.

Q3 How can nomination committee reporting be enhanced to provide sufficient information about the committee's work, including its focus on succession planning and talent management?

Our review of 2014 annual reports: *Annual Reporting in 2014: reflections on the past, direction for the future, September 2015,* highlights our views on leading practice in nomination committee reporting. As part of this work we came up with certain hallmarks of good nomination committee reporting which include:

- Skills, experience and expertise of each board member and how these qualities will be optimised at board level to help the company realise its strategy, instead of just publishing a list of previous positions held by each member.
- Specific details on the board recruitment process including information on external advisers, search and selection criteria, and the quality of candidates (e.g., skills, experience and expertise) sought, found and appointed.
- An overview of when specific non-executive directors are due to leave the board, with an explanation of how and when the resultant gaps in skills etc will be filled.
- An explanation of how the board defines and approaches diversity in practice.
- A description of initiatives that are in place to develop the next cadre of senior management, and an indication of whether emergency succession plans are also in hand.

As highlighted in *Board effectiveness – continuing the journey, April 2015*, some investors say they get more insight into a company's succession plan from private discussions with a company's board. Evidently, the reporting of some succession plans (and disclosures on what the nomination committee has done during the year) is restricted: either due to a lack of planning/activity on the part of these committees, or due to sensitivity about publishing detailed information on their activities.

It is important to recognise that only some of the largest institutional investors have access to boards to hold private discussions such as these. Therefore, to allow a "level playing field" across investor classes and sizes, a nomination committee report should contain enough information - subject to commercial sensitivities - about how it is proactively managing talent and thinking about the skills and experience needed in the future. This should be borne in mind when the next annual report is planned.

Such a report should provide comfort to investors that matters are in hand. They could also use it as a reference point in their conversations with nomination committee chairmen.

Q4 To what extent do you agree with the assertion that those who challenge are sifted out during the recruitment process?

This is a difficult question to answer objectively unless one has seen at first hand the basis on which candidates are rejected. That said, it seems to us that appointment processes which are deemed to be more open and fair are probably more likely to mitigate the risk of candidates being excluded on the grounds that they might question and challenge the status quo.

Training for those involved in the appointment process to help them recognise and control the influence of personal bias, may help to keep the appointment process more open and objective.

Q5 Should the details of the objective criteria used in the search for board candidates be set out in the nomination committee report and if not, why?

Yes, the objective search and selection criteria should be disclosed in the nomination committee report. Investors want to know that appropriate steps have been taken to find and appoint the right person for the job. Some nomination committee reports already include this information which we believe instils investor confidence that the committee is on top of the issues.

However, we have noted that the more objective criteria can sometimes appear similar between committee reports from different companies. There is a tendency here for boilerplate reporting. So we encourage nomination committees to be more specific where possible and open about the "softer" and "subjective" criteria (e.g., cultural fit, social style, ability to challenge) with evidence that the successful candidate was appointed on the grounds that he/she met all or most of the criteria.

Q6 What is your experience of public advertising for non-executive roles?

Companies are better placed to answer this question.

Q7 Are the responsibilities of the nomination committee made clear in the principles and provisions of the UK Corporate Governance Code? Should there be more clarity

There may be scope for more clarity and detail in the Code's provisions on the responsibilities of the nomination committee. For example, the Code has more detail on audit and remuneration committees compared with the nomination committee, and yet the latter can be regarded as the most important committee because it influences the composition of the board and its committees.

The nomination committee provisions could be improved. For example, the audit committee has to report which financial statement issues it considered and how those issues were addressed.

The nomination committee could perhaps report on how significant issues from board evaluations were addressed, in terms of moving, removing and/or adding new members.

Q8 What, if anything, can be done to improve the standing of the nomination committee?

The FRC's call for more rigour and transparency around the work of the nomination committee, and the increased focus by the FRC and investors on the importance of succession planning, should help to elevate the profile and importance of the nomination committee.

Q9 To what extent is the role and operation of the nomination committee a subject for discussion between investors and the board?

Based on our dialogue with investors the work of the nomination committee, or certainly the outcome of its work, is often a topic of discussion between investors and boards. This is evidenced in part by the profile of board appointments and reappointments at AGMs, and the attention given to this by the media. Also, when matters of corporate governance are discussed in the media, especially in the context of a corporate failure or scandal, the story often centres on individual board members and includes speculation on succession.

Investors also tell us that succession is an important matter for discussion with company chairmen. Some have mentioned that they get sight of candidate short-lists (especially in regards to the appointment of a new chairman or CEO) and that sometimes they offer their views on selection criteria with the aim of influencing the final outcome of an appointment.

Q10 What practical changes could help ensure boards fully consider succession planning within the annual evaluation exercise?

The nomination committee should be reviewed as part of the board evaluation. The review should include the committee's board appointment process (e.g., its openness, objectivity, search and selection criteria, role/expectations of individual members, and robustness of the interview process). The review should also cover the succession plan itself (e.g., its relevance to the strategy and extent to which it is regularly reviewed). The board could then report on all of these findings in the annual report and accounts.

Although the UK Corporate Governance Code includes a principle on the evaluation of the board and its committees (B.6), and a provision that the nomination committee should make an evaluation of the board's skills etc (B 2.2), it does not outline what a review of the nomination committee should entail. The FRC should consider whether this needs to be addressed, perhaps offering guidance along similar lines to our suggestion in the paragraph above.

Q11 Would more detailed reporting on changes to a company's succession planning process which resulted from the evaluation of the board be beneficial? What are the barriers to this and how might they be overcome?

Yes, because a bland statement such as 'it was agreed to give more focus to succession planning in the year ahead' is often all that is provided. It would be more meaningful if companies were encouraged to explain: i) what aspects of the succession plan require change; ii) the reasons why change is required (e.g., a revised strategy); iii) what those changes will involve; and iv) when those changes will take effect. Emphasis needs to be placed here on the need for these explanations to be as clear and concise as possible, in recognition that annual reports have grown in length over recent years. Reference could also be made to disclosures on the company's website.

A significant barrier to better reporting of succession plans is the board's understandable caution about the potential commercial sensitivity of making such disclosures. We believe that better reporting can be achieved providing a fair, balanced and understandable account of a succession plan, without divulging information which could compromise the commercial interests of a business.

Q12 Would retrospective disclosure of previous board evaluations be useful and how might companies go about this?

Yes, to an extent. Some companies explain how the results of their board evaluations are actioned over time. They show which issues have been raised in one particular year, and then how they were addressed in the subsequent year(s). This shows a commitment to the spirit of evaluations, and would help to instil confidence in a company's succession planning if proposed changes to that process were also explained in this way.

Companies could be encouraged to report board evaluation findings on, for example, a rolling three-year basis with findings and actions from preceding evaluations shown together. A positive effect of this could be that boards are held to account more effectively, for resolving issues that were highlighted in previous years.

Q13 We would like to know more about the practical use of succession planning matrices by companies, for example: Are there particular situations where they are more useful? Were they developed internally or bought in? Were they used in conjunction with consultants or other service providers?

It would be more appropriate for companies to answer these questions. However, anecdotally we have heard from non-executive directors that matrices are more useful as internal discussion aids and prompts for board and committee meetings.

Q14 We would be interested to learn more about how companies review their internal talent and what development practices they use in support of succession planning.

It would be more appropriate for companies to reply to this question.

Q15 How could companies do more to establish an external 'pipeline', tracking and nurturing external candidates – particularly NEDs?

One way to help establish a more effective external pipeline is to have a clear set of specifications for potential and upcoming "talent gaps" in the board and its committees, clearly communicated to the recruitment advisers. This would enable the advisers to track and register more precisely potential candidates for the company if/when needed.

We have also heard that some chairmen use search firms to identify potential external future successors for their CEO. The chairmen and nomination committee then "keep an eye" on the progress of these individuals, so that they have an idea about potential successors prior to the CEO leaving or retiring.

Q16 What are the best ways to ensure that board members become more familiar with the work of internal candidates and their skills and attributes?

Boards are likely to become more familiar with the work of internal candidates if they interact more often with different parts of the company (e.g., site visits, meetings/discussions with various groups and levels of employee etc).

Also, certain initiatives which may help to augment the internal candidate pipeline, as recommended in our report *Board effectiveness – continuing the journey, April 2015,* can also help boards to become more aware of potential internal candidates e.g:

- Mentoring potential boardroom candidates earlier in their careers e.g., enabling mentees to work in different parts of the business and to attend board meetings.
- Developing potential mentors (board directors), giving them the opportunity to get more involved in succession planning, whilst offering internal candidates more choice and opportunity to find a mentor.
- Encouraging candidates to undertake non-executive roles in other entities (e.g., public, private and/or third-sector).

Q17 How should a succession plan incorporate and deliver diversity objectives?

The process of mapping skills, experience and expertise against a company's strategic plan can help, to some extent, with the diversification of thought and decision making (as well as the more tangible aspects of composition e.g., gender and ethnicity). For example, some companies make sure that shortlists of candidates, for board positions or other roles, are gender-balanced and comprise of individuals with diverse backgrounds and outlooks etc.

By ensuring that the board and company as a whole are diverse, the internal succession plan and pipeline will be more attuned to sustaining this level of diversity i.e., search, selection and recruitment influenced by more diverse thinking and decision making. Succession plans can also deliver diversity objectives by ensuring that effective support systems are in place (e.g., flexible working). This helps to ensure that the best candidates are not deterred or overlooked by the company because of their personal circumstances e.g. home location, parenting or caring roles, disability etc.

Q18 What more can be done and by whom to encourage greater diversity in the boardroom?

Boards and those who advise them on the search and selection of new members should include a gender balance and broader diversity criteria when compiling lists (long and short) of prospective candidates. Boards might also wish to consider the appointment of "board apprentices" e.g., individuals with a dissimilar background compared with the incumbent members of the board (e.g., they might not have plc and/or board experience) but their skills, experience and expertise may nevertheless be relevant to the strategic aims of the company.

However, everyone involved in the appointment process (nomination committees, search agencies and selection panels) need to be mindful that appearances can sometimes be deceptive: that differences in their gender, ethnicity, social background etc do not necessarily equate with diverse thinking or decision making. So all parties involved in succession planning need to be vigilant and allow for disagreements and conflicts of opinion, before any decisions are reached about shortlisting and selecting candidates.

Q19 Do the current Code provisions relating to non-executive directors' independence and length of tenure assist with encouraging diversity and progressive refreshment of the board?

It depends on the industry sector, because some sectors have a longer outlook than others (e.g., extractive companies often have "life of mine plans" spanning 30 - 40 years). Therefore, it may be necessary sometimes for a non-executive director to be on the board for close to nine years. A tenure of this length may be particularly relevant if the incumbent comes from a different industry background, because it may take several years for that person to become knowledgeable about a particular company and its sector(s).

In other sectors the pace of change may be faster (e.g., some business models need to be revised or replaced within a two or three year period) which means that the composition of some boards might lag behind (e.g., ideas and thinking might be slower to adapt to new/changing circumstances) if non-executives remain on the board for nine years or more.

However, we note that the UK Corporate Governance Code includes a provision (B.2.3) for non-executive directors who have served six years on a board to be subject to a 'rigorous review' and the board should 'take into account the need for progressive refreshing of the board'. It would be interesting to hear from companies what this "rigorous review" entails and how it influences outcomes.

The challenge of course is getting the balance right, and for boards to be cautious about the speed and frequency of changes to their complement of non-executive members. It is important that changes are staggered in the interests of boardroom continuity and the sharing of knowledge.

Q20 It has also been suggested that HR and nomination committees should work more closely with executive search firms to identify more diverse candidates. Can you provide examples of how this has taken place?

It would be more appropriate for companies to reply to this question.

Q21 What experience have companies or investors had in terms of engagement about the introduction of new talent to a board?

We are aware of situations where some investors have recommended that a new non-executive director should be appointed (specifying the level of skills and experience required), and then the board rejects the recommendation and objects to the intervention.

We also hear of behind-the-scenes conversations between investors and chairmen prior to appointments being made. Investors tell us that they do not like to be surprised by news that a chairman or CEO has been replaced, but they also say it is not their role to recommend specific individuals for new board appointments.

Q22 What information can be shared constructively between companies and investors on succession planning and talent development and how?

Annual reporting can explain clearly the system the board uses to maintain good succession planning practices, and their oversight of executive succession (e.g., how far ahead they look, how they search, select and appoint new candidates, and what sort of skills, experience and expertise are needed). The same content could also be shared and discussed between companies and investors when the chairman meets with them periodically (e.g., one-on-one or in group presentations).