Financial Reporting Council

May 2016

Feedback Statement:

UK Board Succession Planning Discussion Paper

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries, and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Introduction

In October 2015 the Financial Reporting Council (FRC) issued a discussion paper – 'UK Board Succession Planning' – which sought views on various issues surrounding board succession for both executives and non-executives. The period to respond closed on 29 January 2016. This paper summarises the main points from the responses and indicates the next steps to be taken by the FRC.

The FRC developed its initial thinking through discussions with a wide range of interested parties – both individually and in groups. The discussion paper sought a greater understanding of the key issues and good practice which exist to support a suitably talented, diverse 'pipeline' of directors ready to serve on the boards of UK listed companies.

The issues explored in the discussion paper, and under which this feedback statement is arranged, included:

- how effective board succession planning is to business strategy and culture;
- the role of the nomination committee;
- board evaluation and its contribution to board succession;
- identifying the internal and external 'pipeline' for executive and non-executive directors;
- ensuring diversity; and
- the role of institutional investors.

The FRC's interest stems primarily from the fact that the quality of succession planning is one of the most frequent issues highlighted as a consequence of board evaluation. Stakeholders have suggested that the FRC promotes good practice to raise quality. The FRC also wished to address the Parliamentary Commission on Banking Standards' recommendations to the FRC on issues around director nomination, which commented that there was a 'widespread perception that some "natural challengers" are sifted out by the nomination process. The nomination process greatly influences the behaviour of non-executive directors and their board careers.'

The FRC received 32 responses to the discussion paper. Of these, five were from listed companies, six from investors, two from audit firms, and 11 from representative bodies. The remainder came from individuals and service providers. Copies of all responses, with the exception of those that asked to be kept confidential, are available on the FRC website.

Next Steps

As part of the FRC's Culture Coalition Project we will consider providing nomination committee guidance as part of the revision of the Guidance on Board Effectiveness.

For the current reporting season, the FRC will review and analyse nomination committee disclosures (including board evaluation reporting for the FTSE 350) and comment on our findings in the 2016 Developments in Corporate Governance and Stewardship report.

Summary of responses

Business Strategy and Culture

The discussion paper highlighted the relevant principles and provisions from the UK Corporate Governance Code (‘the Code’) which describe the board’s role in leading the company. The Code makes it clear that long-term business success and good governance go hand-in-hand. We were, therefore, interested to learn how succession planning is aligned with strategic planning and corporate culture, as getting this right will enable boards to select directors best suited to the company’s future direction.

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

The responses described how the use of skills matrices, including personality-related versions to help with cultural fit, and completing a gap analysis of board requirements might achieve a better link to strategy and company culture.

Ensuring the involvement of the chairman and Senior Independent Director (SID) in both shaping a strong board and in underlining the importance of succession was also regarded as essential. Concerns were raised that a strategy and culture driven by the dominant personality of one of two influential individuals was risky and more likely to be unsustainable. It is therefore important that the board understand this risk and how a change in personnel might affect the company’s strategic plans.

It was also highlighted that there can be risks of becoming too reliant on the skills of one individual, such that discussions on tenure at the time of appointment are necessary to help inform and manage the long-term picture of the succession strategy.

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

Reporting on the link between strategy and effective succession planning was considered likely to raise sensitive issues. However, responses indicated there is an appetite for better disclosure, with investors noting that they wish to understand the nature of the skills and experience a board will need in the future and how the company intends to make this transition. The majority felt the nomination committee report was the natural home for such information. The inclusion of targets and metrics were also considered useful.

Many said that companies should be able to clearly connect the succession plan and talent development programme to the corporate strategy. Investors commented that they are interested in how these will contribute to the execution of strategy and the risks associated with not having the right people in place. For instance:

- Is successful execution of strategy dependent on recruitment of key individuals to fill identified areas of vulnerability?

- Will the progress of the strategy create additional demands on management? If so, how is this being factored into the talent management programme?

- What type of information does the board receive on talent development and how does the board use this data to make decisions?

- What influence does the CEO have identifying his or her successor and other appointments to the board? How is this process scrutinised by the chairman and non-executives?

- Do succession plans consider different time horizons? These include:
  - contingency planning – for sudden and unforeseen departures;
  - medium-term planning – the orderly replacement of current board members and senior executives (e.g. retirement); and
  - long-term planning – the relationship between the delivery of the company strategy and objectives to the skills needed on the board now and in the future.

Nomination Committee

This section set out the Code principles and provisions for the nomination committee and reporting. From the initial feedback we had received, it was suggested that greater clarity over the committee's role and responsibilities would be helpful to promote its purpose and standing.

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?

Some respondents felt that sections B.1 and B.2 in the Code already provide a suitable framework to determine the work of the nomination committee. However, the majority believed that nomination committee reporting could be improved and suggestions included:

- information on the committee's purpose and responsibilities, what it has done during the year and what it thinks went well, with links to specific decisions where possible, rather than just reporting on its terms of reference;
- the board recruitment process including information on external advisers, search and selection criteria;
- having greater detail of the process that the committee uses to judge future candidates against the role profile and skills/experience matrix;
- board biographies, directors' relevant skills and competencies, and contribution to board performance to give an overall picture to justify their re-election;
- having more information on how the pipeline of talent is managed, and how this works to support succession planning at senior levels;
- details of the initiatives in place to promote diversity in board and executive appointments, including having an explanation of why the committee is comfortable that the board is suitably diverse;
- the outcomes of the board evaluation process, its proposed actions, and progress with actions from the previous year;
- indicating the existence and review of contingency plans to deal with sudden and unexpected changes in directors;
- a statement of whether succession arrangements are in place for all board members and key management.

It was pointed out that to create a more 'level playing field' across investor classes and sizes, as only some of the largest investors have access to boards to hold private discussions, the 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.

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

From the evidence presented we cannot conclude that 'natural challengers' were sifted out of the recruitment process. In fact the opposite view was often given, i.e. that being constructively challenging is an integral part of the non-executive role. The term 'effective challenger' was used instead to refer to an individual capable of providing both support and challenge to the board as the situation demands. However, there was also a view that the need of some boards to ensure a ‘fit’ with current board dynamics may have led to candidates without previous board experience being viewed as a riskier choice. One investor suggested that companies with poor governance may self-select weaker non-executive directors that do not challenge management.

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?

Reporting of objective criteria was not considered an easy task by companies, due to the sensitive nature of the information. It may be understood wrongly to highlight any potential or perceived lack of skills or experience on the current board and could be seen as price sensitive information. There was a mixed response to this question with significant disagreement. However, investors said they wished to know that appropriate steps have been taken to find and appoint the right person for the job, so including some of this information would seem a helpful disclosure to make.

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

Public advertising did not have many supporters and there was no evidence given of its usage. Most respondents believed companies should be free to decide whether they wish to advertise publicly to fill board roles. Although public advertising may offer access to a wider range of candidates who might otherwise be overlooked, recruitment methods need to be appropriate to a particular company's requirements. Indeed the companies who responded said they did not consider it an effective method of recruiting individuals of the calibre, or with the skills and experience, they required. However, there was support for a more transparent appointment processes as beneficial to all concerned.

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 about the role of the board?

On the whole respondents said the Code provisions were clear about the nomination committee. Some suggested more detail on the nomination committee’s responsibilities and that its report should include detail on how significant issues from the board evaluation were being address in relation to board appointments. Although expanding the Code further on the subject of succession planning was mentioned, greater emphasis was given instead to providing additional guidance.

Many responses said that while nomination committees may not be directly responsible for talent management they should be fully aware of how the company manages it in practice in order to make judgements about succession planning.

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

In order to raise the status of nomination committees investors preferred disclosures in annual accounts and investor meetings to focus on the effectiveness of the board. The starting point of governance discussions should be about company purpose, strategy and culture: are the right personalities, skills and experience available on the board to give companies the best possible chance to succeed? To increase focus on succession matters, the nomination committee could schedule in regular meetings to ensure that board succession is given the attention it requires on a formal basis. Another option would be to expand the remit of the nominations committee beyond board succession planning. For example, some companies already combine the nominations committee remit with oversight of corporate governance matters, thereby giving its activities an increased profile.

One investor commented that the nominations committee and the remuneration committee should work closely together, particularly in agreeing remuneration for executive appointees to the board. This would help to ensure that remuneration structures incentivised executive directors to deliver long term performance beyond their own tenure, for example through minimum holding periods of shares, which would help ensure a focus on succession planning.

Some respondents noted that the view that the nomination committee is the “Cinderella” committee is not borne out in larger companies. The fact that a number of companies' nomination committees have their most senior or long-standing directors serving on the committees is evidence of this. Others said the nomination committee has a less technical function and is not driven by the compliance requirements of the audit and remuneration committees.

One company said that fewer meetings should not be regarded as an indicator of less importance. A nominations committee must take a longer term, strategic view of board composition, talent management and succession planning, reviewing talent and developing succession plans that may span over several years. This does not necessitate the same frequency of meetings as other board committees, which focus on monitoring and advising on business performance and risk issues.

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

The overall view from responses suggested that board composition and succession planning are often discussed as part of wider engagement with investors but there is little specific discussion on the role and operation of the nominations committee. Investor interest in the operation of the nomination committee varies depending on the circumstances of individual companies. In normal circumstances there is satisfaction that the nomination committee is functioning well however, in exceptional circumstances, an activist investor may be closely involved – possibly up to the point of recommending candidates for consideration as new appointments to the board.

One respondent highlighted the need for more information about the relationship between the nomination committee and the remuneration committee in external recruitment. In particular, whether consultation had taken place about agreeing a remuneration package.

Board Evaluation

The discussion paper highlighted the value of board evaluation and gave examples of how a comprehensive regular board assessment which included succession planning was essential.

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

There was general support for the ideas in the discussion paper, in particular the importance of the chairman setting a tone of transparency and openness. There was also some agreement about the setting of objectives at board, committee and individual director levels in order to benchmark to measure performance.

Other suggestions included that:

- directors identify the attributes that they bring to the board thereby enabling the nomination committee chairman to use this to build up a blueprint for the operation of the board and to strengthen it by planning succession at an early stage;

- the nomination committee should be reviewed as part of the board evaluation, including the board appointment process (e.g. openness, objectivity, search and selection criteria, role/expectations of individual members, and robustness of the interview process);

- the board evaluation review should cover the succession plan itself (e.g. its relevance to the strategy and extent to which it is regularly reviewed);

- the setting of personal objectives should include establishing a plan for any development needs and, as part of the performance review process, the completion of this plan should be assessed;

- non-executive director induction should be formalised and link more explicitly to on-going development;

- boards use the opportunity of a board evaluation to assess their composition and agree plans for increasing diversity; and
- board reviews encompass composition and benchmarking as well as communication, culture and dynamics.

An overall view was that board evaluations should inform and influence succession planning and that while succession planning should be included it should not be considered only once a year as part of the annual evaluation, but rather be regarded as a continual process. Investors commented that they appreciate hearing from companies that they have separate board sessions on succession planning, as it is important enough to have its own agenda.

Would more detailed reporting on changes to 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?

There were mixed views on this, with some companies saying that more detail in this area would not be helpful as there are many personal issues which would complicate an already delicate process. A significant barrier to better reporting of succession plans is the board's caution about the potential commercial and personal sensitivity of making such disclosures.

Investors thought that in order to makes the process more meaningful, companies should be encouraged to explain:

- what aspects of the succession plan require change;
- the reasons why change is required (e.g. a revised strategy);
- what those changes will involve; and
- when those changes will take effect.

Overall investors felt that current disclosure about board evaluations is insufficient: most companies report that they undertook a board evaluation and that the board is operating effectively. It would be more helpful to understand what aspects/topics the evaluation looked at, what weaknesses were found (in general terms), and what mitigation the company will take to address any concerns. It is important that board evaluation does not only focus on the effectiveness of the current board in dealing with today's challenges, but also gives insight to the needs of the future board in the context of the company's strategy.

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

A number of respondents noted that there continue to be issues with confidentiality and sensitivities which may limit what can be disclosed. Some went on to say that it is likely to discourage directors from undergoing full and rigorous board evaluations as these should be carried out in an environment which encourages directors to challenge and question both fellow board members and those reporting to them. Any public disclosure on board evaluations would hinder such practice.

However, attention was drawn to some companies which explain how the results of their board evaluations are actioned over time. They disclose which issues have been raised in one particular year, and how they were addressed in the subsequent year(s). This demonstrates a commitment to the spirit of evaluations and holds boards to account more effectively to resolve issues. Furthermore, investors noted that the quality of disclosures is improving, although they would value more disclosure around the outcomes of the board evaluation, rather than a focus on its process.

Succession planning matrices: 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?

Companies reported that they tended to use internally developed skill matrices but some had external consultants assist in their creation. One investor thought they should be developed through a mix of internal deliberation and external expertise. For small and mid-size quoted companies with limited resources, it was suggested that such analysis should be carried out through the annual board performance review meeting. The disclosure of matrices to shareholders was regarded as useful to show both the skills needed now, and those required in the future.

Pipeline

The discussion paper focussed on the importance of preparing a solid pipeline of high quality internal candidates who can be ready for senior management and board positions in a range of situations.

How do companies review their internal talent and what development practices do they use in support of succession planning?

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

Talent management was highlighted as a strong motivational force for employees who wish to develop their career within the company and achieve senior positions thereby providing a variety of strong internal candidates. Respondents, therefore, pointed out that the nomination committee should consider taking a more active interest in talent management.

We received detailed submissions, particularly from financial institutions, about the methods used to identify, develop, track and prepare internal candidates for senior management and board positions. A variety of approaches are used, which include broadening and deepening experience within the business through a controlled mix of postings, professional development in terms of 360 degree reporting, coaching and assessment in terms of corporate values and behaviours. Internal candidates may also be externally benchmarked. In larger companies this is often operated by a specific team in the HR function.

A number of respondents talked about the need for those who are on track for being considered for board positions to be exposed to directors and board experiences. This should happen, as a matter of course, when they present to the board on matters related to their responsibilities. However the nature, variety and frequency of interaction between the board and aspiring board candidates should be considered carefully. There are other approaches which will bring directors into contact with employees such as meetings on site and more informal situations – open sessions, lunches and dinners. To promote diversity, it was suggested that this should be integrated into the development process from the very beginning.

Some respondents referred to the need for the board to be involved in assessing more layers of management and the fact that this was becoming more prevalent practice. Nevertheless reticence was expressed about the resource needed for this and there was concern about where to draw the line in terms of board involvement in HR functions. There was also little revealed about the practical nature of interaction between the nomination committee and the HR function.

How might companies establish an external pipeline of candidates?

Two respondents advocated the use of board apprentice schemes. Under these schemes apprentices spend a period of time attending board meetings and undertaking other forms of development such as mentoring or coaching. This builds the experience and credibility of the candidate. Such arrangements are also helpful in promoting diversity. It was acknowledged that take up of apprenticeships would be more suitable in some companies than others.

The role of executive search advisers was highlighted. It was suggested that there needed to be better two-way communication between them and nomination committees. There should be specification for potential and upcoming vacancies on the board which should be clearly communicated to recruitment advisers. This would assist them in monitoring potential candidates. At the same time search firms should support the nomination committee by taking a more creative approach to the external succession pipeline. One respondent referred to the short term nature of the recruitment market and how this might militate against the establishment of external pipelines.

Diversity

The discussion paper drew attention to the changes made to the Code in terms of diversity reporting and definition, the work of the Davies Review and benefits of diverse boards.

How should a succession plan incorporate and deliver diversity objectives?

Practical suggestions included aligning succession planning internally with the organisation's diversity strategy and externally with the Davies report and recommendations. The succession plan could be used to restate diversity objectives; to emphasise the breadth of diversity (i.e. not just gender); to state the business case for board diversity; to outline the relationship between board and executive committee diversity; and to set out targets, including how to achieve and review these.

Most responses felt it was critical that any incorporation of diversity in the succession plan was part of a holistic approach to diversity and inclusion in the organisation – for instance the need for all employees to have diversity and inclusion objectives or for search firms to be appropriately briefed, as well as looking at diversity at a senior level.

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

This question attracted the highest number, and the most substantive, responses. A great many issues were raised, with a particular focus on issues surrounding search, selection and the pipeline – in particular to broaden the potential talent pool. The very fact that individuals do not fill 'conventional' criteria is likely, of itself, to bring valuable additional perspectives to board strengths. However, there is also caution against 'diversity for the sake of diversity' – boards must be clear about the particular skills needed and assess these objectively. Furthermore, boards as a whole should be better informed about the link between diversity, strategy and business value. Diversity should be considered as a broad concept in order to encourage diverse thinking and to avoid the dangers of groupthink.

In particular:

Chairman/CEOs/nomination committee chairs – should show leadership, link diversity with long term strategy and business needs, be encouraged to take more risks when hiring.

Boards – need to think more broadly about what is likely to constitute suitable previous experience, both in terms of demographic profile and in terms of previous relevant board experience. The criteria and the process for identifying candidates need to be reviewed with consideration given to the concept of board apprentices. Also need to understand unconscious bias and the impact it can have on (recruitment) decisions.

Human Resources Functions – must give consideration to role specifications to take account of diversity (is the language, remit, selection process and package inclusive?); set targets and review progress; annual report should outline progress and look at the impact of selection processes on diverse candidates; support employee networks to address different areas of diversity.

Search consultants – should be pressed to look more broadly for talent; be given guidance about what is expected; and have the confidence to challenge appropriately where boards do not appear to be open minded to diverse candidates.

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?

Comparatively few of the respondents answered this question in detail, responding instead with agreement with the Code's aims or more general statements – there is general approbation of the ideas behind the independent non-executive director length of service 'rule' and the ability to 'comply or explain' if this is exceeded. A small number feel the provision should be more strenuously enforced, and there is a concern that mergers/IPOs allow the clock to be 'reset'.

Specific responses included the need to treat different industry sectors differently – there may be some where the outlook for the particular industry requires a much longer tenure and therefore limiting a director's tenure might not be so appropriate. There is a careful balance to be struck between continuity/not losing expertise and the need for board refreshment.

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?

Practical examples were thin on the ground. One outlined how the chairman had recruited new non-executive directors following the review of the skills needed from the current board and the resulting gaps identified and anther how specialist firms could tap into particular talent pools. Several respondents said that HR was rarely or never involved in the search for non-executive directors but that search consultants were generally better aware of the need for diversity in the current climate. The use of a matrix of skills was seen by one respondent as a concrete way to ensure the right focus on what is precisely needed. The chairman and board themselves are seen as critical in changing the culture and attitudes necessary to diversify board recruitment.

Institutional Investors

The discussion paper emphasised the part that major investors play in connection with succession planning and with the wider aspects of the board and its role in governing the company's strategic direction. Ongoing engagement is very important.

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

A number of respondents commented that there has been limited engagement on board effectiveness and talent management. There were exceptions to this – some chairmen actively encourage regular and pro-active dialogue with shareholders and understand that obtaining shareholder approval saves time in the long run. One response said the nomination committee chairman answering questions at the AGM would help ensure a better level of accountability. Inevitably, investors said that they do not like to be surprised by news that a chairman or CEO has been replaced, but they also do not see it as their role to recommend specific individuals for new board appointments. There was some reluctance on the part of investors to receive information that would result in them becoming insiders.

There was some awareness about how boards monitor executive directors and the next management tier down to focus on the introduction of new talent and examine the succession agenda. A number of investors reported, from conversations with chairmen, that there appears to be more effort by non-executives to gain more regular exposure to management as part of the succession strategy. In some cases, companies have brought senior management (in addition to the CEO/CFO) to shareholder meetings with the aim of introducing these individuals to the investment community.

It was suggested that nomination committees should consider a potential non-executive director's track record as an executive. The committee should also understand how such an appointment would be received by shareholders and be able to justify this decision. One investor said it would not necessarily resist the appointment of an individual who had been involved in situations of corporate distress or underperformance.

Boards should set guidelines with external recruitment agencies on what they are looking for in terms of diversity of experience, skills, gender and ethnicity. They should be willing to push back and challenge executive search firms if they are not getting the types of candidates they want. The question of succession can arise as a related topic in engagement discussions on remuneration issues in relation to key executives. Flawed pay structures or poor pay outcomes can be exacerbated by ineffective succession planning processes and it is important that these factors are borne in mind by both companies and investors.

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

There is some hesitation by investors to become directly involved in suggesting candidates for recruitment. Investors said that most of what they learnt about the quality of the board and succession planning came from public disclosures. As such, a number commented that the quality of reporting in this area could be greatly improved. Annual reporting can explain clearly the system the board uses to maintain good succession planning practices, and their oversight of succession, for example: how far ahead they look, how they search, select and appoint new candidates, and what sort of skills, experience and expertise are needed.

Companies should also consider:

- providing greater company specific detail in the nominations committee reporting;
- describing the process of nominations and board succession;
- discussing the reasons for changes, e.g. to introduce more independent challenge or diversity, improving the quality of conversations, or filling a gap in experience;
- stating why they believe the board is sufficiently diverse, e.g. that all geographical areas covered by the business are represented, as too with age groups and gender;
- describing more informatively organisational culture, to aid the understanding of how a company views its culture, which may impact future selection decisions;
- providing more meaningful biographies of individual directors, why they are on the board, what skills/experience they fill, how they are working together, what they are contributing;
- including information on the quality of the internal pipeline, as well as what the company is doing to improve it; and
- describing how board evaluations are linked into succession planning.

Investors would like to know more about how internal talent is nurtured and developed for the purpose of succession, and to what extent the executive team and the board think diversity is a component in planning and managing the pipeline of talent. While there is a limit as to how much boards can share, particularly when they are actively recruiting, investors would like assurance that these matters are considered effectively so as to avoid a situation where the issue of succession becomes the 'elephant in the room'.

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