QUILTER CHEVIOT

RESPONSIBLE INVESTMENT

State of Independence

Experience versus independence: How long should non-executive directors' tenure be in the US?

Over the last proxy season, we spent time thinking about how to approach different governance standards in different geographies. As an example, in the US, it is common for the chair and chief executive to be the same person, whilst in the UK this is frowned upon. Furthermore, the definition of an independent director is quite different: in the UK, a tenure exceeding nine years for a non-executive director (NED), calls into question their independence. However, in the US a NED with a tenure of over 20 years might still be regarded as independent.

There are frequent shareholder resolutions in the US calling for the separation of the CEO and chair roles. The presence of a lead independent director on the board is often a reason proxy voting advisers and companies recommend voting against such resolutions. However, what does independent really mean? We have evaluated the standards across the companies within our centrally monitored universe and have engaged with the third-party funds we invest in to understand how they approach this. As a first step we have examined the standard practices for board composition in the US, particularly focused on:

- tenure
- independence
- compensation
- combined CEO/chair roles, also known as CEO duality.

We have evaluated these factors against standard practices in the UK whilst being mindful that governance rules and norms are different in these two geographies, therefore we are not seeking to apply UK standards elsewhere but use these to inform our evaluation. Finally, we have analysed the board composition of Quilter Cheviot's centrally monitored US companies to identify trends and outliers and to inform our expectations moving forward.

Approver: Quilter Cheviot Limited 18 January 2024

Tenure

Despite the UK's equity market accounting for only 3.8% of the MSCI All Countries World Index[1], it is considered a leader in corporate governance. This includes its approach to director tenure, which is dictated by the UK Corporate Governance Code and applies to all listed premium companies[2]. According to the Code, a NED's tenure (this includes the chair, and there is no 'reset' when a NED becomes a chair) should not exceed nine years, and directors who have served longer than nine years will not be considered independent.

The US is a different ball game with no regulatory limits on how long a NED can serve and how tenure may impact their independence. The country-specific guidelines of proxy voting advisers such as ISS and Glass Lewis, as well as the voting policies of large institutional investors (like BlackRock[3], Vanguard[4], and State Street[5]), do not specify a time period after which a NED is considered non-independent.

According to data from an executive search firm, in 2022, the average tenure for NEDs in the US was 7.8 years and 4.3 years in the UK[6]. This is unsurprising as this will comprise new and existing NEDs and therefore the numbers will reflect this. If we take the UK number of 4.3 years which is roughly equal to half the mandated maximum tenure of nine years, can we extrapolate this for the US in thinking about what a maximum tenure number should be? In the case of the US this will extrapolate to 16 years if we adopt this not very scientific approach.

This difference in approach can be seen when looking at US boards, where it is not unusual to find independent directors with tenures of over ten years; in some cases, this includes the chair (where there is a separation of the chair and CEO roles) or the lead independent director (where one person has both the CEO and chair roles).

> *The UK Code states that the chair should not remain in post beyond nine years from the date of their first appointment to the board. A NED's independence becomes impaired when they have served on the board for more than nine years from the date of their first appointment. However, it is common in the US for NEDs to sit on a board for ten or more years.*

Benefits of longer tenure

Boards often argue that having long-serving NEDs helps retain corporate memory, but this view doesn't reflect the full picture. While we agree that this can be beneficial during significant upheavals, however these should be rare occurrences. Boards should establish succession plans to avoid excessive tenures.

Effectiveness of directors

A study conducted in 2018[7] on a group of US companies discovered that the effectiveness of directors follows an inverted U-shaped curve with regards to their board tenure. This means that their efficacy improves rapidly during the first few years, reaches its peak at years eight to ten, and then decreases again. The study found that this tenure is linked to share price, as well as merger and acquisition performance, financial reporting quality, and CEO compensation. Based on empirical observations, it was concluded that the optimal tenure range is between eight to ten years.

1 Why the UK equity market is shrinking | MoneyWeek
2 UK Corporate Governance Code | Financial Reporting Council (frc.org.uk)
3 blk-responsible-investment-guidelines-us.pdf (blackrock.com)
4 Proxy voting policy for U.S. portfolio companies (vanguard.com)
5 proxy-voting-and-engagement-guidelines-us-canada.pdf (ssga.com)
6 Boards Around the World | Spencer Stuart – this compares the S&P 500 (US) to the largest 150 companies in UK.
7 Zombie board: Board tenure and firm performance (core.ac.uk)

Board independence requirements

The UK Corporate Governance Code requires that at least half the board, excluding the chair, should be independent[8]. However, given the US's more relaxed attitude towards tenure and how it may define independence, the US has a higher proportion of 'independent' NEDs than the UK; 86% versus 73% respectively[9].

The UK Code indicates that companies must state which non-executive directors are independent in the annual report. The Code outlines a number of conditions which can compromise the independence of a NED including:

- If a director has had any recent employment or business relationship with the company,
- received additional remuneration,
- has close family ties with company members,
- holds cross-directorships,
- represents a significant shareholder,
- or has served on the board for over nine years.

Finally, companies need to disclose any other circumstances that might affect a NED's independence.

For investment trusts given the opportunities for conflicts of interest between the board and the investment advisers, we believe that fully independent boards present the best outcome for shareholders. Grudgingly, we will make an exception for the handful of investment trusts that have significant family ownership. However, we will do so only in the knowledge that the board has significant independent representation and strong leadership from the chair.

Compensation of non-executive directors

Compensation for independent non-executive directors in the UK typically involves an annual fee. Performance-based incentives and share options are avoided by companies to maintain compliance with the UK Corporate Governance Code and ensure impartiality. Nonetheless, the Investment Association backs the idea of NEDs receiving a portion of their salary in shares, if these are purchased at market value and without performance conditions attached[10]. It is notable that smaller companies are more likely to offer share-related compensation to NEDs.

Conversely in the US, NEDs are often paid in shares; because of this one proxy voting service provider's guidelines for US companies recommends stockholding requirements of at least four times annual fees, or more when the equity portion of the pay is significantly higher than the cash component. However, performance-based incentives are also viewed as controversial.

> *Non-executive directors are elected representatives of shareholders and not company employees.*

In the UK companies are required to put their remuneration policy to a binding vote at least every three years[11]. In the US, the Introduction of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010[12] meant that companies are required to have a say-on-pay vote at least once every three years. However, unlike the UK, this is an advisory vote.[13] On occasions, boards will engage with a remuneration consultant in order to amend the policy, in which case, best practice indicates that the consultant should be named in the annual report. The International Corporate Governance Network (ICGN) guidelines[14] suggest that boards should also provide a summary of the advice provided by said consultant.

8 Contents (frc.org.uk) Except for smaller companies where the requirement is for at least two independent NEDs.
9 Boards Around the World | Spencer Stuart – this compares the S&P 500 (US) to the largest 150 companies in UK.
10 Principles of Remuneration 2022 - Final.pdf (theia.org)
11 The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (legislation.gov.uk)
12 SEC.gov | Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act
13 Investor Bulletin: Say-on-Pay and Golden Parachute Votes (sec.gov)
14 ICGN Guidance | ICGN

CEO/chair

In the US (as well as France and Spain) it is common for the roles of CEO and chair to be combined; in those cases, the presence of a lead independent director on the board is critical to ensure the appropriate checks and balances are in place.

According to a paper by the Conference Board,[15] in 2021, 43% of the companies in the S&P 500 index had combined CEO /chair roles. This number has been decreasing steadily since 2018, when it was just over 50%.

In our view,to improve board effectiveness; there should be no doubt that the non-executive chair or the lead independent director are independent. However, the key question is, how we determine independence.

The UK Corporate Governance Code, states that *"The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board."* Having separate positions allows for a balance of powers, making sure that no one individual has absolute control of the company.

There are UK-based investors which are openly vocal against the combination of roles in any jurisdiction, for example Legal & General Investment Management.[16]

The UK Code explicitly states that the roles of chair and CEO should not be combined. However, the US does not have a corporate governance code, and the combination of these roles is often observed.

Our centrally monitored universe of US equities

For this research, we have analysed board composition data for the 99 companies in our US monitored universe. As previously stated, there are significant differences in tenure practices between the UK and US markets.

1. CEO/chair

As previously mentioned, a combined CEO/chair role, is common in the US with 43% of the S&P 500 following that model in 2021. This number is even higher in our monitored universe with 55% of companies having a combined CEO/chair.

It is considered best practice for a company with a combined CEO/chair to appoint an independent lead director.

The role of the chair can take on various forms:

- **CEO/chair**: both the same person performs both roles.
- **Executive chair role**: when the CEO transitions to the chair role; for example, in 2021 Jeff Bezos, founder of Amazon, moved from the CEO/chair role to become the executive chair[17].
- **Non-executive chair**: When the chair is a non-executive; alongside this they may be classified as independent or non-independent.

Chair by type – Position	Percentage
CEO/chair	55%
Executive chair	11%
Independent non-executive chair	27%
Non-independent non-executive chair	7%

15 The Conference Board | Trusted Insights for What's Ahead (conference-board.org)
16 North America corporate governance and responsible investment policy (lgim.com)
17 Email from Jeff Bezos to employees (aboutamazon.com)

2. Longest tenures

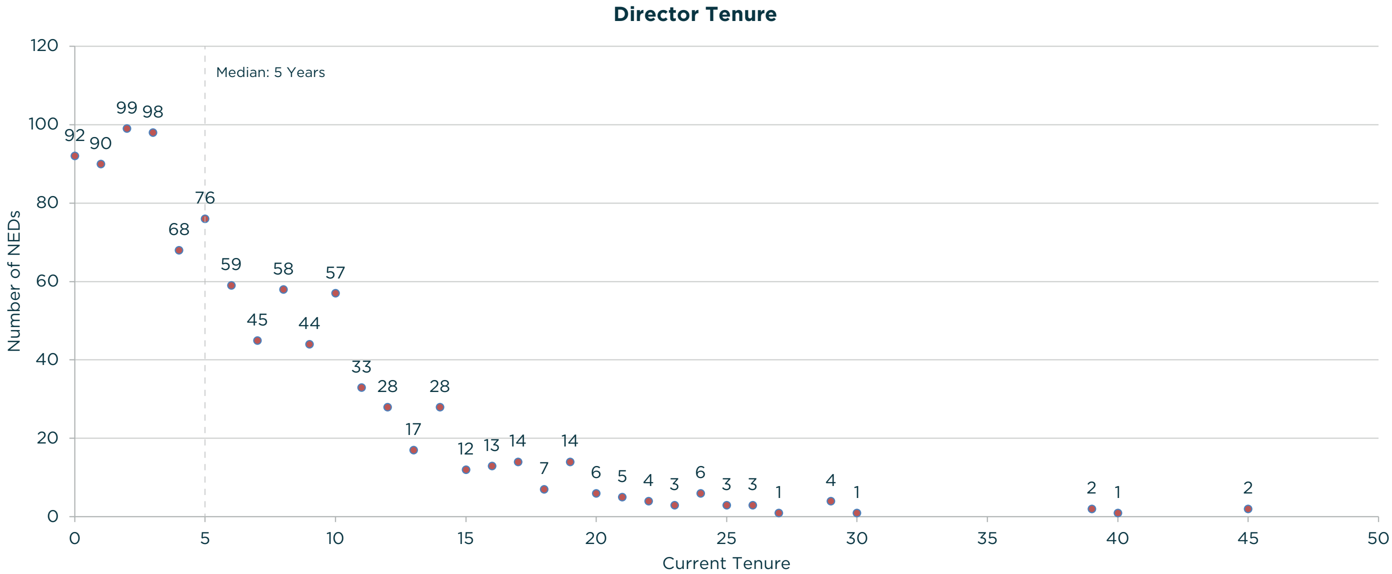
Out of the 99 non-executive chairs in our US universe the longest tenures are:

Position	Longest tenure
Independent non-executive chair	27 years
Independent lead director	25 years
Non-executive director	47 years

3. Average and median tenure

The average tenure for non-executive directors in our universe is 6.8 years; this figure comprises new and existing NEDs and therefore the numbers will reflect this. In this instance 92 new NEDs were appointed to these companies in 2023 and have zero years tenure. The average tenure on our monitored list is lower than the US market but higher than in the UK. Independent lead directors have an average tenure of 11 years, while non-executive chairs have an average tenure of around 13 years.

The chart below shows all the non-executive directors in our US-monitored companies. Each dot represents the number of directors that currently stand at that tenure. The further to the right, the longer the tenure. As we can see, many directors have over nine years of tenure.



4. Directors over tenured

We wanted to determine how many companies would exceed different tenure thresholds if we were to assess them against different time limits. We have assessed this based on identifying companies that have at least one non-executive director with a tenure of over ten,12 and 15 years. So, in this case if we used ten years as a tenure limit, we would vote against the re-election of at least one NED at 85% of our US monitored companies.

Companies with directors over:		
10 years	**12 years**	**15 years**
85%	73%	52%

Third-party managers

We examined the voting guidelines of our third-party managers to determine their views on the tenure of NEDs in the US market.

- Most managers did not have specified limits on NED tenure, while only a minority had hard limits.
- One manager explicitly stated that tenure is not a factor that affects independence.
- Another indicated that it would vote against non-independent NEDs directors who have been on the board for more than 15 years.
- Another approach taken is to examine the relationship between the directors, for example, voting against directors who have served together for 20 years.
- Some investors look at the average tenure and vote against the longest-standing directors if it exceeds their internal threshold.
- Most managers who have a policy do not explicitly state what they consider to be an excessively long tenure.

Additionally, we contacted a couple of third-party managers who invest in the US to get their opinions on NED independence and the issue of CEO duality. As anticipated, most of the investors are reasonably relaxed when it comes to extended tenures and combined CEO/chair roles. Please note that these opinions are specifically related to the US market.

- **UK based manager**: Regarding the combination of CEO and chair roles, the manager believes that each strategy has its own merits and should be decided on a case-by-case basis. Before voting, the manager asks a number of questions to ensure there is sufficient independent representation on the board. Extended tenures are not a concern for this manager, as they are seen as part of market norms.
- **US based manager**: The investor prefers independent directors to have less than ten years tenure. When non-executive directors are approaching the ten-year mark, it asks companies about their succession plans. However, there are no set guidelines on this issue, so it needs to be examined on a case-by-case basis. This manager tends to support the separation of the CEO and chair roles; however, it is usually comfortable with a strong lead independent director.

Outcome

In conclusion, the question of defining independence remains difficult. If we think about tenure, the US takes a different approach as evidenced by the average NED tenure being double that in the UK market. Furthermore, the UK Corporate Governance Code stipulates that a NED is not considered independent after nine years.

After analysing the US companies in our monitoring universe, we will consider directors with a tenure of more than 15 years as non-independent. We will then assess the independence of the entire board, and if the number of non-independent directors exceeds 50%, we will withhold votes from the non-independent directors. We have identified the companies in our monitoring universe that meet these requirements, and we will be writing to them to inform them of our position.

Ramón Secades
Responsible Investment Analyst

Quilter Cheviot
Senator House
85 Queen Victoria Street
London EC4V 4AB
+44 (0)20 7150 4000

To find out more please contact your investment manager or email: marketing@quiltercheviot.com

quiltercheviot.com

Investors should remember that the value of investments, and the income from them, can go down as well as up and that past performance is no guarantee of future returns. You may not recover what you invest.

QUILTER CHEVIOT

SPECIALISTS IN INVESTMENT MANAGEMENT

(01/2024)