RESPONSIBLE INVESTMENT

Succession: evaluating board tenure in the EU

Maintaining an effective and independent level of decision making and oversight is key for a board and forms an important part of corporate governance. It is an area we focused on during the last proxy season and we are now reevaluating how to approach different governance standards relating to director independence in different geographies. A non-executive director's (NED) independence hinges on several factors, including material relationships, significant holdings and tenure. The UK Corporate Governance Code states that 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, this is not necessarily the case in other geographies. Therefore, we have undertaken a review of tenure limits in the US and Europe. This paper focuses on Europe and how we should approach tenure when assessing voting decisions on board independence. We have analysed the centrally monitored equity holdings across Europe, (currently 95 companies)[1] and identified where NEDs have potentially excessive board tenures. European companies differ from our holdings in the US and the UK, as it is not uncommon for companies to be operated by a founding family, with a number of family members having seats on the board, ultimately impacting the overall levels of board independence.

To be clear we are focused on the tenure of non-executive rather than executive directors.

Tenure

Boards are under increasing levels of scrutiny in terms of long-tenured NEDs. However, there are conflicting views on the topic. Advocates of shorter board tenures consider finding a balance between a desirable level of expertise, and ensuring the board maintains fresh perspectives to be the key factor in board performance. Long-tenured NEDs run the risk of becoming entrenched in the business, impairing their ability to provide independent oversight which is central to their role. While opponents of more stringent tenure measures argue that long-tenured NEDs provide a deeper wealth of knowledge and understanding of the company and promote board stability.

1 Quilter Cheviot's centrally monitored European direct equities as at 31/12/2023.

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Corporate governance standards regarding board tenure differ by region. These differences can make it challenging to form a cohesive assessment of board independence, and subsequent voting approach. As referenced above, in the UK, nine years is considered to be the maximum term, however in the EU, best practice is 12 years[2], however, it is common for individual countries across Europe to set their own best practice guidelines on NED independence. For example, across Ireland and Italy, any NED serving over nine years is considered to have exceeded the recommended tenure limit and should have independence called into question. However, it is worth noting, that companies listed on the principal Irish market are required to follow the UK Corporate Governance Code.[3] Companies across the US have a more liberal approach to classifying director independence than in the EU, and defined term limits have not been set, more details outlined in our parallel report on US NED tenure.

Quantitatively speaking, the European Commission clearly lays out its expectations for companies domiciled in the EU regarding NED independence. There is an expectation that the majority of the board is independent. From the outset, this expectation provides us with a baseline to assess all companies by.

Unitary versus two-tier board

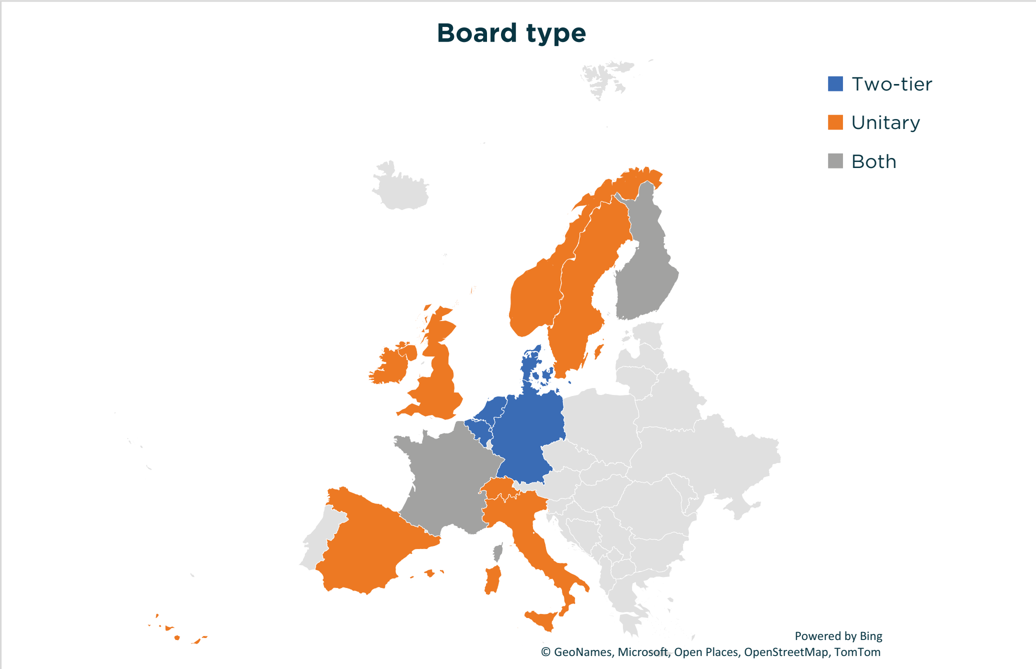
The board of directors provides a mechanism to govern a company. More specifically, NED's duties include strategic planning, nominating board members and establishing board committees which focus on specific functions. A board is typically structured in one of two ways: unitary and two-tiered. Within a unitary (single) structure, one board handles the long-term management of the company. Whereas in a two-tiered structure, the management team executes business on a day-to-day basis and the supervisory board overseas the executive board and is assigned to the long-term planning and decision-making. In these instances, we classify overall board independence based on the structure and NED tenure of those who sit on the supervisory board. The Belgian Corporate Governance Code[4] outlined below has laid out a useful categorisation guide, which is broadly applicable across the EU.

Terminology in the code	One-tier structure	Two-tier structure
"board"	board of directors	supervisory board
"board member"	member of the board of directors - director	member of the supervisory board
"non-executive board member"	non-executive director	member of the supervisory board
"independent board member"	independent non-executive director	independent member of the supervisory board
"executive management"	executive directors and members of an executive committee	management board
"executive"	executive director or member of an executive committee	member of the management board

Out of the 12 countries we actively vote in across the EU, five have a have a two-tier board structure, five a unitary structure and two countries (France and Finland), maintain a mixture of single and two-tier board structures.

Where companies employ a two-tier board, it is also common for employee representatives to sit on the supervisory board. For example, in Germany, employees have co-determination rights through their works council, meaning they have representation on the supervisory board.[5] Given employee representatives are company employees and so inherently non-independent, such appointments can significantly impact the independence of the board. Typically, companies with two-tier board structures have larger boards overall, so the presence of employee representatives can be counterbalanced by a larger number of non-executive directors.

2 Independent directors.3 (ecoda.eu)
3 Corporate Governance in Ireland | ECGI
4 2003973319-1651062453_1651062453-2020-belgian-code-on-corporate-governance.pdf (corporategovernancecommittee.be)
5 German Codetermination | DGB German Trade Union Confederation



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Over tenured directors

Out of the 95 companies analysed, nine have at least one non-executive director whose tenure exceeds twelve years. In all instances where this is the case, the NED has been classified as non-independent by our proxy advisor. Where overall board independence falls below 50 percent, we have voted against the re-election of the NED where possible. The main exception is in Germany where employee representation on the board is a legal requirement. In these cases, we expect one-third of the supervisory board to comprise of independent non-executive directors.

A significant hindrance to addressing board independence is the presence of multi-year director elections. For example, across France, directors are elected to serve multi-year terms, where directors are up for re-election every four years. European countries also differ from the US and the UK in the way the boards are structured. In the UK re-elections are usually on an annual basis. This difference in term structure presents a challenge when a board does not meet our independence expectations and the NEDs responsible are not up for re-election. Ordinarily, we would vote against the chair of the nominations committee, however, this action may not be an option. Therefore, where a board has multi-year election process, it is difficult to hold the board to account in the same way we would when all directors are re-elected on an annual basis.

Broadening the scope, the EU performs better than the US in not having overly tenured NEDs, evidenced by 9% EU companies falling short of our expectations, in comparison to 52% in the US. This takes into consideration the stricter guidelines imposed on EU countries for a director to be considered independent, 12 years, where we have set 15 for the US.

Companies with NEDs with tenure over:	
15 years (US)	12 years (Europe)
52%	9%

Outcome

Typically, within the EU, NEDs who serve over 12 years are considered to be non-independent, and in the majority of cases where less than 50% of the board is not independent, we will seek to express our disapproval by voting against the re-election of the non-independent NED and/or the chair of the nominations committee. The exception is Germany, given the high employee representation on the boards. In this instance, the hurdle for independence is lower, at 30%. As noted previously, this is not always possible given the lack of annual re-elections in most of these geographies. While defined, our approach is not fixed and where board structure is weighted towards a family ownership style, we will assess on a case-by-case basis. Maintaining board independence is key to corporate governance and we will monitor our European holdings closely to identify if they fall short of this and what action should be taken. As per our stewardship process, we seek to engage with a company on our vote decision on a best-efforts basis.

Kirsty Ward
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