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Term Limits for Directors

Should there be a limit on the number of years an individual may serve on a board? Governance committees should put the issue of "term limits" on their meeting agenda.

Arguments in favour of term limits – Term limits are seen by many as a way to refresh the board on a regular basis. Scheduled retirement dates for directors facilitate board succession planning. They create opportunities to bring new skill sets onto the board and to move underperforming directors off the board. Term limits are also seen as a means to accelerate turnover among boards, allowing organizations to address issues such as gender imbalance in a meaningful way. Current governance thinking is looking to term limits as a means of reinforcing the independence of the board from management. The concern is that long serving directors have too little distance from management and are accordingly less able to discharge their oversight function effectively.

Arguments against term limits – Critics of term limits believe that issues relating to individual directors should be dealt with by a strong chair and thoughtful governance committee and that the board is best placed to recommend to the shareholders candidates for election who will contribute the right skills and qualities to the board. Organizations face challenges and directors who are steeped in the organization's history and culture often play an important role in seeing it through a crisis. Boards that impose term limits may find that they lose valued directors just at the time when the organization needs them most. Mandatory retirement ages pose the same risk and many boards have very much regretted the loss of key directors to retirement policies that seem unnecessarily arbitrary and inflexible when they force a high performing director off the board.

International trend toward term limits – Although term limits are not common in Canadian public companies, investors internationally are encouraging boards to consider board tenure. The International Corporate Governance Network (an investor-led global governance organization) recommends that the length of tenure of each director be reviewed regularly by the nomination committee to allow for board refreshment and diversity. In the UK, best practice guidelines encourage term limits by deeming directors not to be independent after nine years of service; in France after 12 years. Australian guidelines leave the issue with the board, but recommend that the boards consider whether a director's independence has been compromised after 10 years of service.

Canadian landscape – The case for term limits in Canada has not yet been made, but may be evolving. While there are examples of Canadian directors serving for 15, 20 and even 30 years on a board, this is exceptional (we note that a recent Clarkson Centre survey found that 84% of directors of S&P/TSX Composite Index issuers had been on the board for less than 10 years). A 2013 ISS survey found that institutional investors "generally appeared hesitant" to impose strict term limits. Several large institutional investors have specifically rejected the routine adoption of term limits and the Canadian Coalition for Good Governance notes that boards should not rely on term limits as a means for dealing with underperforming directors.

Still, governance committees should watch for changes in sentiment on the term limit topic. One of Canada's largest institutional investors supports term limits, noting that they contribute to board vitality. Another states that it is the board that should decide whether terms limits (and age limits) are appropriate. Although neither ISS or Glass Lewis supports or reject term limits in its proxy voting guidelines, both proxy advisory firms are clearly thinking about the issue. Glass Lewis states that if a board has adopted term limits, they should be strictly applied (no waivers). ISS' governance risk assessment tool for US issuers notes that a tenure of more than nine years potentially compromises a director's independence.

Do term limits promote better governance? US studies on the impact of director tenure on board effectiveness have drawn a range of conclusions. One study of S&P 1500 companies has linked long-serving directors, and directors who serve on many boards, with failures in corporate governance – although another study based on a similar sample concluded that companies with a higher proportion of directors with extended tenures had lower CEO pay, higher CEO turnover-sensitivity following poor performance and a smaller likelihood of intentionally misrepresented earnings. A large statistical study of audit committees suggests that long standing independent audit committee members have greater expertise and experience to effectively oversee financial reporting. Other research has suggested that firm value tends to rise as the average tenure of directors reaches nine years, but declines after that.

What should the governance committee do? The governance committees must stay abreast of emerging governance trends and term limits should be on their radar screens. They should consider whether term limits would enhance the effectiveness of their board and keep a careful watching brief on the views of investors on the issue. If the term limits are already in place, the governance committee should consider their impact on board effectiveness and whether any change is desirable. Finally, the governance committee should consider disclosing in the issuer's annual governance disclosure to shareholders, whether it considers length of tenure in re-nominating incumbent directors for directors and the reasons that the board has or has not adopted term limits for its directors.

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