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Corporate Boards Need Term Limits

COMMENTARY By Theresa Hamacher June 23, 2022 3:00 am ET

Corporate board term limits won't resolve all the issues boards need to address, but they are a good place to start, writes Theresa Hamacher.
Dreamstime

*About the author: **Theresa Hamacher** is the chair of the board of the Morningstar Funds Trust and president of consulting firm, Versanture Consulting, LLC.*

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There's been a debate for many years about the nature of corporate board term limits. One position argues that enforcing term limits for boards is short-sighted, because it deprives shareholders of years of experience and valuable insights. This was the position I supported in the past, and I even co-authored an opinion piece stating that the trend toward board term limits is based on faulty logic and threatens performance.

Today, as chair of the board of the Morningstar Funds Trust, I realize the reasoning behind that position was flawed. Term limits, such as the 15-year cap adopted by our board, play a critical role in strengthening the independence of directors and new research illustrates why.

Directors aren't good at self-reviews

I previously argued, along with other critics of board term limits, that rigorous annual review of the performance of each director would ensure boards functioned as intended despite the inherent flaws of the review process.

The reality is, however, that directors are not good at self-assessments. If they were, 47% of directors wouldn't be saying that at least one director on their board should be replaced, as they did in PwC's 2021 survey of corporate directors. (By the way, 18% of directors said they would replace two or more of their colleagues.)

Self-assessments do not ensure a high level of performance because, for most boards, the process is flawed. In the same PwC survey, 52% of directors felt that these self-assessments were "too much of a 'check the box' exercise," while 67% agree with the statement that "there are limitations to being 'frank.'"

Perhaps one of the issues is the lack of assessments of individual directors. In their most recent survey on the subject, PwC found that only 61% of corporate boards conducted director-level evaluations. And only 20% of mutual fund boards drill down on individual director performance.

Tenure is over-rated

In addition to overlooking the flaws of board self-assessments, the value of tenure is also miscalculated. In 2015, I cited a study that found that longer tenures are directly correlated to better corporate outcomes.

But a more recent study from Singapore Management University finds that the relationship between tenure and effectiveness may be more complicated. "Zombie Board: Board Tenure and Firm Performance," published by Sterling Huang and Gilles Hilary in 2018, concludes that directors are most effective in the middle years of a long tenure, after they have become acclimated but before they've become entrenched.

Clearly, both the wisdom gained from tenure and familiarity with current issues are valuable to boards. For instance, mutual fund boards benefit from both long-term experience evaluating investment performance through various market conditions and from exposure to more recent changes to the marketing and distribution landscape.

However, directors are likely to over-emphasize tenure, simply because of inertia. While directors don’t need to do anything to accrue tenure, they must take conscious steps to gain new experience.

Turnover is vital to diversity

Critiques of board term limits also gloss over the link between term limits and diversity. Board turnover is critical to diversifying boards. Typically, boards wait until a director retires to address diversity and inclusion issues.

According to PwC data, 69% of boards rely on such openings to include diverse directors, compared to 33% who increase their board size to do so.

There is clear evidence that term limits are connected to diversity. In their Pace University School of Law research, “Board Diversity by Term Limits?” Darren Rosenblum and Yaron Nili found that gender diversity increases as board tenure decreases, based on their study of S&P 1500 companies between 2010 and 2016.

Improving oversight requires joint effort

Both directors and shareholders need to take proactive steps to improve boards. Directors should consider how term limits might improve the performance of boards while making them more inclusive.

That doesn’t mean, however, they should view term limits in a vacuum. They are part of a wider array of measures, including reviewing retirement policies and self-assessment practices, that can lead to better outcomes for shareholders. In addition to a 15-year term limit, our board has adopted a mandatory retirement age of 75 as well as a policy to annually assess individual directors.

It’s also critical that boards adhere to policies once they’re adopted. Boards frequently raise their mandatory retirement age. For mutual fund directors, the most common mandatory retirement age was 72 in 2012, compared to 75 in 2021, according to Management Practice, Inc. annual survey data. And there are worrying signs that retirement ages will continue to rise.

Shareholders, for their part, need to ensure directors are refreshing their boards appropriately. Shareholders have focused on promoting some level of diversity and inclusion. But they need to approach board scrutiny with a more comprehensive, long-term view of the policies and practices of boards, particularly ones that lack diversity.

Ultimately, term limits won’t resolve all the issues boards need to address, but they are a good place to start.

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