AGENDA

OPINION

Board Committee Structure

Enterprise risk management considerations are opening questions about committee structure

By William Regner | December 4, 2023

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Board committee structure is a hot topic in corporate governance, particularly as companies wrestle with emerging risk management issues such as cybersecurity and artificial intelligence. But board committees, and the reasons for forming them, are not new.

General Motors had an audit committee as long ago as 1939, and the U.S. Securities Exchange Commission first recommended in 1940 that companies have independent audit committees. It took a while for the idea to gain broad currency: Audit committees were not common until the 1970s. It was only in 1977 that New York Stock Exchange listing rules required independent audit committees, and only in 1987 that Delaware prescribed by statute that directors were fully protected in relying in good faith on reports of board committees.

Yet the appeal of using board committees to improve decision-making and divide labor is hardly novel. The board of directors of the East India Company, chartered in 1600, had 16 committees by 1813 — although none was an audit, compensation or nominating and governance committee.

Today, NYSE and Nasdaq rules require listed companies to have independent audit committees and, for non-controlled companies, independent compensation and nominating committees. In practice, a significant majority of large companies have more committees than that.

As of 2022, about three-quarters of S&P 500 companies had at least one additional board committee, typically either an executive, finance or compliance committee. Companies in regulated industries, such as financial services, telecommunications and utilities, average more than two additional committees.

Many companies struggle with the question of board committee structure: What committees should the board have, who should serve on them and what should their responsibilities and particular qualifications be. This is particularly true when emerging issues, such as environmental, social and governance issues, technology (including cybersecurity and AI) and compliance risk, begin to demand more time and attention from directors. When thinking about committee structure, it can be helpful to recall why committees have been formed in the first place.

There are two principal reasons boards form committees: first, to strengthen independent decision-making, and second, to divide labor, with the goal of reducing the overall burden on the board and ensuring that appropriate focus is brought to bear on specific topics.

The audit committee, for example, was always conceived of as a committee of directors independent of company management.

Like many other innovations of corporate governance, it traces its origins to a financial scandal — namely, the McKesson-Robbins scandal of 1938, in which, after a decade-long fraud by company management, the company's audited financial statements were found to include fictitious assets, sales and profits. The SEC's report investigating that scandal recommended independent audit committees as a way of strengthening auditor independence.

Later, in the wake of other financial scandals (Enron, WorldCom, Tyco), Congress passed the Sarbanes-Oxley Act of 2002, which appeared to embrace both principal reasons for board committees. It sought to strengthen independent decision-making by requiring the SEC to adopt rules requiring listed companies to have independent nominating/corporate governance committees, and it sought ensure appropriate subject matter focus by requiring rules making companies disclose whether their audit committees have at least one "audit committee financial expert" — or else explain why not.

Yet another scandal — the financial crisis of 2007-2008 — resulted in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and its requirement for independent compensation committees.

Other common board committees, such as executive committees and finance committees, are focused less on independence and more on the second reason for committees: division of labor. For this reason, they often include inside directors.

There is some correlation between company size and the number of board committees. While 75% of S&P 500 companies have more than three board committees, only about 45% of Russell 3000 companies do. Presumably this reflects the basic idea that directors of larger, more complex companies will benefit from dividing the workload.

When considering how directors might tackle any emerging area of board concern, the following are logical questions to ask:

1. Would the company and its board benefit if the topic is delegated to a board committee, or should the full board retain primary responsibility for the matter?

2. Is the topic of a nature that makes it important that only independent directors take primary responsibility for it?

3. If the topic is to be taken up by a board committee, should a new committee be formed or is it logically adjacent to the work of an existing committee?

4. Which directors are well suited to take up the topic?

Sometimes the answers to these questions will present an obvious solution, but not always. For example, human capital is often assigned to the compensation committee, not because it is an area rife with potential conflicts of interests, but rather because the subject matter is naturally adjacent to employee compensation.

ESG, on the other hand, presents a mix of issues, with governance particularly benefiting from supervision by only independent directors, and environmental and social issues benefiting primarily from being considered by those with subject matter interest or expertise.

As a result of the first consideration, a majority of companies end up assigning ESG to the audit committee. But a number of companies have separated the topics of corporate responsibility and sustainability from that of governance and have assigned those to its own committee, in part because the nominating committee usually already has responsibility for governance matters.

When considering emerging topics that benefit primarily from subject matter focus rather than independence, companies are often led to consider whether they should add new directors with relevant expertise.

While this is an appropriate topic for consideration, it carries with it a potential risk, which also arises more generally from the proliferation of board committees: that atomizing board expertise will undermine the collective decision-making that is at the heart of board function.

This risk can be mitigated by focusing on the qualifications of each director beyond specific subject matter expertise, and also by considering whether all directors should be invited to attend committee meetings, so long as that does not compromise the independence of committees where that is important.

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