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The Determinants and Effects of Board Nomination Committees★

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Abstract. This article assesses the corporate governance-related antecedents of nomination committee adoption, and the impact of nomination committees' existence and their composition on board independence and board demographic diversity. We conducted a longitudinal study of board composition amongst 210 Swiss public companies from January 2001 through December 2003, a period during which the Swiss (Stock) Exchange (SWX) introduced new corporate governance-related disclosure guidelines. We find firms with nomination committees are more likely to have a higher number of independent and foreign directors, but not more likely to have a higher number of female board members. Further, the existence of nomination committees is associated with a higher degree of nationality diversity but is not related to board educational diversity. We also find that nomination committee composition matters in the nomination of independent and foreign, but not of female directors. Our results suggest that understanding different board roles and composition require a multi-theoretical approach, and that agency theory, resource-dependence theory and group effectiveness theory help to explain different aspects of board composition and effectiveness. Finally, the article discusses the concept of diversity and appropriate ways to study diversity in a boardroom context.

Key words: board demographic diversity, board independence, nomination committees

1. Introduction

Corporate governance codes typically encourage boards to establish nomination committees for the purpose of identifying and selecting new members. Nomination committees are believed to improve the board's effectiveness

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through managing its composition, e.g. by raising directors' qualifications and board independence. Despite an increase in nomination committees' existence (cf. Gay, 2001), they have been largely overlooked in the academic literature. In the wake of accounting and executive pay scandals, research has rather addressed the role and effects of audit and remuneration committees (Conyon and Peck, 1998; Klein, 2002), and the presence of independent directors (Baysinger and Butler, 1985; Dalton et al., 1998). The issue of board composition is, however, vital to board effectiveness and performance and ultimately helps to ensure that the "right" persons are selected as audit and remuneration committee members.

The essential problem of board composition is widely discussed and studied in the governance literature, yet mostly from an agency theory perspective and with a primary concern on directors' independence. From an agency perspective, boards are the main internal mechanism to monitor and control firm managers and it is crucial therefore that corporate directors are independent from firm management. Yet, empirical evidence suggests that this is not often the case (Useem, 2003; Monks and Minow, 2004). Furthermore, it is often questioned to what extent corporate directors have the necessary knowledge and expertise to perform their board roles and make actual contributions (Westphal, 1999; Carpenter and Westphal, 2001). These lines of criticism suggest that board composition is a key contributing factor in their efficacy. A possible explanation for these observations can be found in the behavioural view of the firm (Simon, 1947; March and Simon, 1958; Cyert and March, 1963). According to the behavioural view of the firm, decision-making may be intendedly based on rational motives but is also influenced by cognitive human limitations. According to Simon (1947) such limitations include bounded rationality and satisficing (not maximising) behaviour. Hence, organisational decisions are limited first, by the cognitive limits of decision makers, such as limited knowledge of the factors relevant to the decision or the influence of personal values, preference and previous decisions and second, by not considering and evaluating all possible alternatives (satisficing behaviour).

If applied in the context of boards, a behavioural theory of the firm can help explain board composition patterns that differ from agency theory predictions. On the one hand, current corporate directors are subject to bounded rationality, and as a result, when searching for new officers may choose new board members who are similar to them and whose characteristics they believe they know well. When lacking clear selection criteria and decision procedures, board appointment decisions may be influenced to an extent by such behavioural limitations. Nomination committees, with established working procedures, can be seen as an important institutional mechanism to overcome the limitations of the board selection process. By developing board member profiles and establishing selection criteria, perhaps using the services of search firms and interviewing candidates, nomination committees professionalise the selection process and ultimately optimise new director selection decisions.

In this article, we examine the extent to which board composition differs in firms with and without nomination committees and how committee composition influences board composition. This issue is important as changes in board composition can be expected to shape behavioural processes and practices in and around the boardroom (Zahra and Pearce, 1989; Forbes and Milliken, 1999). There are also distinct reasons to investigate the role of nomination committees. First, research on the link between overall board composition and firm performance has often produced inconclusive findings (Dalton et al., 1998). Consequently, some scholars have recommended focusing on boardroom dynamics and board processes (Pettigrew, 1992; Forbes and Milliken, 1999; Stiles and Taylor, 2001). Other scholars note that the composition, functioning and impact of board committees demand attention since "many of the critical processes and decisions of boards of directors do not derive from the board-at-large, but rather in subcommittees" (Dalton et al., 1998, p. 284). Second, despite widespread public interest in who is actually on companies' boards, the effects of nomination committees on board composition and the appointment of new members has not been established. The few existing studies on nomination committees look at characteristics and qualifications of board committee members (Kesner, 1988; Bilimoria and Piderit, 1994), or at the factors determining the introduction of such committees (Vafeas, 1999; Carson, 2002). Finally, agency theory offers only a partial view (solution) to the board composition problem. We therefore rely on a multi-theoretical approach to provide a broader view on board composition and board roles and the role that nomination committees play in making board composition decisions.

Various researchers have pointed at the limitations of using a single theory to explain board composition and behaviour (Eisenhardt, 1989; Aguilera and Jackson, 2003; Hillman and Dalziel, 2003; Lynall et al., 2003). We adopt a multi-theoretical approach examining the antecedents and effects of nomination committees, drawing from agency theory, resource-dependence theory and group effectiveness theory. Here these theories are not understood primarily as rival streams of thought, but provide alternative perspectives to look at the selection and nomination of board members.

This article assesses the corporate governance-related antecedents of nomination committee adoption and the impact of nomination committees' existence and composition on board independence and board demographic diversity. A longitudinal study of board composition was conducted amongst

210 Swiss public companies from January 2001 through December 2003. Halfway through this period, in July 2002, the Swiss Stock Exchange (SWX) introduced new guidelines (based on the 'comply or explain' principle) requiring listed companies to make boards more transparent, and to report on the composition of committees and boards in their annual reports (SWX, 2002). This study covered the 18 months preceding and the 18 months following the introduction of the new guidelines, enabling us to assess the role nomination committees play in the transformation process of corporate boards.

The structure of this article is as follows. First, we develop our theoretical framework and derive our hypotheses on the factors influencing the adoption of nomination committees and the effect of nomination committees on board independence and demographic diversity. Second, we explain our sample and the methodology of this study. We then proceed to present our main results and finally discuss the findings, identify study limitations and suggest implications for further research.

2. Theoretical Perspectives and Hypotheses Development

2.1. THEORETICAL PERSPECTIVES

Governance research has been criticised for over-emphasising the control role of boards and thus relying primarily on an agency theory lens to explain board behaviour. Recent work encourages investigators to adopt a multi-theoretical approach to understanding board composition, roles, and their effects on the firms they supervise (Daily et al., 2003, p. 372). In this article, we use different theoretical lenses to explain antecedents and consequences of nomination committees' existence. We draw upon agency theory (Jensen and Meckling, 1976; Fama and Jensen, 1983; Jensen, 1993) to explain governance-related factors influencing the adoption of nomination committees. In order to understand the effects of nomination committees on board composition, we relate their purpose to existing theories of board roles. Zahra and Pearce (1989) emphasise that board composition and roles are interwoven and define three main board roles: control, service and strategy. As these three roles are theoretically and practically distinct, Hillman et al. (2000) argue that their implications for board composition need to be studied by using distinct theories. Based on agency theory we explain nomination committees' role in enabling boards to perform their control role effectively. The resource-dependence perspective (Pfeffer, 1972; Pfeffer and Salancik, 1978) regards directors as boundary spanners between firms and their environments. Based on this view, nomination committees' purpose is to adjust board composition to the demands posed by a firm's external environment. Finally, we draw on the group effectiveness and diversity literature (Milliken and Martins, 1996; Williams and O'Reilly, 1998) to explain how board diversity will enhance a board's ability to perform its strategy role successfully.

Agency theory is primarily concerned with the implications of the separation of ownership and control in modern organisations (Berle and Means, 1932) and the resulting principal-agent problem (Jensen and Meckling, 1976; Fama, 1980; Fama and Jensen, 1983; Jensen, 1993). The theory questions managers' motivation to act in the best interest of the shareholders instead of following their own self-interest. A number of internal and external control mechanisms may reduce the latent agency or moral hazard problem between principal (owners) and agent (management). Agency theory asserts that a board of directors is a vital internal control mechanism and characteristics such as board independence *vis-à-vis* management enable boards to perform this control function effectively (Baysinger and Butler, 1985; Barnhart et al., 1994). Eisenhardt (1989) argues that agency theory offers a powerful, yet rather narrow theoretical perspective. Agency theory only deals with one aspect of board work (i.e. monitoring management) and does not address other roles that boards may play within their corporations (Zahra and Pearce, 1989; Hillman and Dalziel, 2003). Agency theory also fails to explain motives of human behaviour, other than self-interest, that might guide managerial decisions (Davis et al., 1997).

Resource-dependence theory (Pfeffer, 1972; Pfeffer and Salancik, 1978) is increasingly employed by researchers in broadening the study of board roles and behaviour (Gabrielsson and Huse, 2004). Resource-dependence theory moves beyond the owner–management–board relationship and focuses on the link between a firm and its environment. The premise of resource-dependence theory is that firms are dependent on their external environments which are characterised by a high degree of uncertainty. According to resource-dependence theory, the role of boards is to act as *resource providers*, or boundary spanners, between firms and their environments, to secure the firm's access to critical resources, to increase its legitimacy towards the outside world and thus to reduce environmental uncertainty (Pfeffer, 1972; Pfeffer and Salancik, 1978). Resource-dependence theory extends the discussion of board roles and takes into account not just directors' status or independence and ability to perform their monitoring function effectively but also directors' skills, knowledge and expertise, background characteristics and network contacts.

While the control and service role of boards have been discussed extensively in corporate governance research over the past few years, less attention has been paid to a third role: A boards' *strategy role*. The few studies linking board composition to board effectiveness in performing its strategic role base their arguments on agency and resource dependence perspective (e.g. Zahra and Pearce, 1990; Rindova, 1999). In this article we argue that borrowing from group effectiveness/diversity theories may enrich our understanding of how directors contribute to a firm's strategy making. The social psychology literature has established that group diversity enhances decision-making (for a review see Milliken and Martins, 1996; Williams and O'Reilly, 1998; Jackson et al., 2003). The underlying assumption is that variance in group composition leads to a broader range of perspectives, skills and knowledge. As a result, diverse groups will be on average more creative and innovative, and thus enhance boards' problem-solving ability. Similarly, upper echelons theory suggest that under certain conditions top management team diversity can be beneficial for strategic decision making (Hambrick and Mason, 1984). Diversity theories can aid our understanding of how board composition patterns affect board processes and ultimately board effectiveness (Forbes and Milliken, 1999).

Boards of directors thus face multiple and complex tasks, subsumed under the controlling/monitoring, the boundary spanner/service provider, and the strategy roles. When selecting new directors, boards need to evaluate existing abilities and future tasks along each of these three roles. In this article, we regard the above three theories as complimentary perspectives in explaining nomination committee antecedents and consequences. The three theories do not violate each others' underlying assumptions. Instead, they rather complement each other by addressing board roles from different angles. Whereas agency theory focuses on the firm owner–management dynamics and defines the board's role in this particular relationship, resource-dependence theory takes the perspective of a corporate board linking a firm to its external environment and focusing on a board's task of establishing fruitful relationships with external parties. Organisations are believed to be constrained by their environments and resource-dependence theory explains a board's role in managing the complexity of a firm's external environment. Finally, group effectiveness theory shifts the focus to the board itself and its working practices and behaviour. Thus the three theories applied in this study allow a comprehensive view of board roles by considering the contexts in which board work is embedded, namely, team context, firm context and the broader environmental context.

2.2. DETERMINANTS OF NOMINATION COMMITTEE EXISTENCE

In the United States, the director selection process has long been subject to criticism as powerful CEOs, rather than shareholders, often *select* directors (Mace, 1971; Pfeffer, 1972; Westphal and Zajac, 1995; Monks and Minow, 2004; Van Ees and Postma, 2004). Although shareholders will ultimately *elect* directors to govern a corporation, they typically have the choice of either accepting in good faith management nominated directors or initiating a proxy challenge with very limited chance of success (Vafeas, 1999). In Europe, the latter may not even be an option (Prigge, 1998; Hofstetter, 2001). The *de facto* control that management has over the board selection process has raised questions as to the extent to which directors can be effective monitors in accordance with agency theory logic (Jensen, 1993).

As an improved decision-making mechanism, off-board nomination committees can help resolve the power asymmetry between corporate boards and management by reducing managerial influence on the selection process of new board members. The nominating committee – like other off-board committees such as audit or compensation – is technically a committee of the board (and thus decisions need to be ratified by the board as a whole), rather than a separate organ reporting directly to shareholders at the annual meeting. However, the existing distribution of power between a board and the company CEO is likely to affect the director nomination process (Hermalin and Weisbach, 1988; Finkelstein and Hambrick, 1996). Specifically, CEO duality enables CEOs to exert a strong influence on all aspects of board work (Monks and Minow, 2004), including the nomination process (Westphal and Zajac, 1995). Thus, CEOs who simultaneously serve as Chairmen of the Board will be less likely to favour the adoption of a standing nomination committee which could reduce the CEOs' influence on the selection of potential board members and can in the long run lead to changes in the management-board power dynamics.

Hypothesis 1a: *Firms that have CEO duality are less likely to have a nomination committee.*

The board of directors is only one control device to align the interests of management and owners in modern corporations. An agency theory perspective suggests a number of other control mechanisms, though such governance mechanisms are typically associated with certain costs. Shleifer and Vishny (1997) note that ownership concentration will result in higher incentives for shareholders to monitor firm management. If a large shareholder directly monitors firm management, the importance of other control mechanisms such as boards of directors may diminish (Rediker and Seth, 1995). Likewise, a large shareholder may also play an important role in selecting new board members, limiting the involvement of the CEO and inside directors in the director selection process. Hence, in the presence of a large shareholder it is less likely that boards will have a nomination committee.

Hypothesis 1b: *Firms that have higher concentration of ownership are less likely to have a nomination committee.*

2.3. BOARD ROLES AND NOMINATION COMMITTEE EFFECTS

2.3.1. *Monitoring role*

Agency theory suggests that the major function of a board is to monitor firm management. The CEO has an interest in having more inside directors on the board, as inside directors work closely with him on a daily basis and will be less likely to challenge his opinions. However, nomination committees can play a vital role in enhancing board members' independence and reducing the influence of management (Jensen, 1993; Firstenberg and Malkiel, 1994; Westphal and Zajac, 1995; Westphal, 1998). The introduction of a nomination committee effectively delegates the director selection process to a group (instead of to a single person), which is independent from the executive management and powerful enough to make independent recommendations. Thus, nomination committees are more likely to heed shareholder interests by assuring that newly selected board members will be outside directors who possess the necessary expertise to accomplish their roles while having no employment relationship with the firm. A higher ratio of outside directors will enable the board to act independently from the firm's management and to perform its monitoring role effectively (Zahra and Pearce, 1989).

Hypothesis 2a: *Boards of directors that have a nomination committee will have fewer inside board members.*

Agency theory suggests that effective monitoring requires not only a majority of outside directors but also conditions to ensure that outside directors are independent from management (Baysinger and Butler, 1985; Barnhart et al., 1994). Kosnik (1987) found that different types of affiliations of outside directors have different effects on a board's ability to protect shareholders' interests. Directors who previously served as inside directors of the company or currently have any type of professional or personal relationship to the management may arrive at biased judgments. Hence, nomination committees are more likely to be concerned with board members' independence, i.e. nomination committees are likely to ensure that newly appointed outside board members have no business or personal affiliation to the company or to its inside directors (as opposed to companies without nominating committees). Thus:

Hypothesis 2b: *Boards of directors that have a nomination committee will have a higher number of independent board members.*

2.3.2. *Link to a firm's environment*

As companies internationalise and face global competitive pressures, they are likely to search for directors who will link them to the international environment in which they operate. Selecting foreign board members is a logical step for companies with high levels of operations and sales abroad. Foreign directors bring knowledge and expertise about a particular market or region and in-depth understanding of the institutions and culture from outside the familiar institutional context (Perlmutter and Heenan, 1974). Further, foreign board members allow the firm and its management to gain better access to international networks (Athanassiou and Nigh, 1999). From a resource-dependence perspective (Pfeffer, 1972; Pfeffer and Salancik, 1978), foreign directors are invaluable in linking the company to foreign environments where uncertainty is particularly high. Particularly European companies, in an increasingly international business environment and rising levels of international sales and employment, are hiring foreign nationals at the top levels of their organisations (Ruigrok et al., 1999; Heijltjes et al., 2003). Having a foreigner on the board helps a company to better understand and cope with the complexity it faces when operating abroad. Therefore, nomination committees are likely to be concerned with attracting and hiring foreigners as corporate directors.

According to resource-dependence theory (Pfeffer and Salancik, 1978, p. 193) firms are parts of larger social systems and as such need to comply with social norms and values. Legitimacy is one of the key benefits expected from boards as environmental linkages (Hillman et al., 2002). Corporate boards have an important role associated with the signalling of organisational intentions and purpose to the outside world (Stiles and Taylor, 2001). Companies establish nomination committees to align board characteristics and structure with external expectations, thus maintaining or improving the public perception of the firm. Companies often change their board composition and governance practices in line with investor norms (Zajac and Westphal, 1996). With the increasing internationalisation of investors and financial markets, there is a growing pressure to meet the expectations of foreign shareholders by selecting foreigners as corporate directors. For example, Oxelheim and Randøy (2003) found that the appointment of an Anglo-American director on the board of a Scandinavian company had a positive effect on firm value. We argue that in the absence of a committee charged with considering boardroom composition, companies may be likely to overlook such benefits. Thus, nomination committees serving the interests of the shareholders are likely to select some foreign nationals as potential board members.

Hypothesis 3a: *Boards that have a nomination committee will have a higher number of foreign directors.*

In recent years, there has been a growing public interest in the share of female board members. The corporate world is criticised for creating a "glass ceiling", not allowing women to reach the upper echelons of their organisations. However, whereas societal pressures to enhance female representation at the top are increasing, the actual number of women serving on corporate boards has increased only marginally (Daily et al., 1999) or even decreased (Singh et al., 2001). Prior research has pointed at a number of valid reasons to hire more women on corporate boards. Women bring different values and perspectives, which can enrich the dynamics of a boardroom. Participative boards (characterised by equal power distribution between the CEO and the board, allowing for discussion, debate and disagreement) were found to be associated with a higher ratio of female board members (Pearce and Zahra, 1991). Further, having a woman on the board sends positive signals towards the outside world. Several studies have found a relationship between the representation of women on the board and firm value (e.g. Carter et al., 2003). Daily and Dalton (2003) note that investors are increasingly including female representation on boards as an investment criterion and the absence of gender diversity on a board may result in negative publicity for the firm. Hence, women directors are an important resource linking the firm to its external environment and nomination committees concerned with aligning board composition with the societal and investor expectations are more likely to nominate female board members.

Hypothesis 3b: *Boards that have a nomination committee are more likely to have a higher number of female directors.*

2.3.3. *Strategy role*

Corporate directors not only serve as individuals providing valuable resources but also constitute a group responsible for formulating and assessing a firm's strategy (Zahra and Pearce, 1989). Group effectiveness theories propose diversity as a crucial resource to improve decision-making (cf. Milliken and Martins, 1996). Group diversity provides access to a larger information base, enabling groups to gain a better understanding of environmental complexities, explore a higher number of different solutions, and ultimately produce better decisions (Cohen and Bailey, 1997; Williams and O'Reilly, 1998). Especially in the context of strategic decision-making, diversity and range of perspectives are crucial for high quality decision-making (Finkelstein and Hambrick, 1996; Carpenter et al., 2004). In this study, we focus on two dimensions of diversity, namely, nationality and educational diversity.

We previously addressed the benefits associated with having a foreign board member. While the presence of a foreigner on a board will be one source of diversity, ultimately the *diversity in nationality backgrounds* will increase a company's ability to cope with pressures from different cultural and institutional environments. Directors originating from a variety of national backgrounds create a boardroom with a high degree of cultural diversity. Despite conflicting evidence, some research suggests that over time, nationality heterogeneity may have a positive influence on team performance (Watson et al., 1993; Cox et al., 1991; McLeod and Lobel, 1996), notably also at the top management team level (Elron, 1997; Earley and Mosakowski, 2000; Richard et al., 2004). In a longitudinal study of American companies, board diversity in terms of ethnic background was found to be positively associated with financial indicators of firm performance (Erhardt et al., 2003). Nomination committees charged with considering such issues as board composition are thus likely to seek to achieve higher degrees of diversity in directors' national backgrounds.

Hypothesis 4a: *Boards that have a nomination committee will have a higher degree of nationality diversity.*

A second type of board heterogeneity that can contribute to improving board strategic decision-making is educational background. Background diversity, as defined by Williams and O'Reilly (1998), has two main dimensions: functional and educational background diversity. The underlying argument for both types of diversity is that functional and educational backgrounds are associated with diversity in information and perspectives. Individuals with dissimilar backgrounds and experiences possess different knowledge, skills and expertise, which when brought to a team decision-making process, will increase its quality (Jackson, 1992). Whereas functional diversity is a critical resource for top managers concerned with the daily operations of a business, it is a less important asset for board members. Diversity in educational background, however, may provide a broader scope of inputs at the more abstract level of the board, enabling its members to support inside directors in strategy formulation and evaluation. Therefore, we expect that the introduction of a nomination committee will lead to more diversity in educational backgrounds of board members.

Hypothesis 4b: *Boards that have a nomination committee will have a higher degree of educational diversity.*

2.4. NOMINATION COMMITTEE'S COMPOSITION AND ITS EFFECTS ON CHANGES IN BOARD COMPOSITION

The previous hypotheses assumed that the introduction of a standing nomination committee *per se* has an impact on the selection of new board members. However, the composition of the nomination committee is also likely to influence the selection of new board members. For instance, an inside director serving on the nomination committee may be less likely to seek to appoint a new board member who is independent from management. Research shows that powerful CEO's can affect the composition of boards (Shivdasani and Yermack, 1999; Golden and Zajac, 2001) and that nomination committees – like most other sorts of off-board committees – are mostly comprised of outside directors (Kesner, 1988; Bilimoria and Piderit, 1994; Conyon and Peck, 1998; Vafeas, 1999). The effects of nominating committee composition have not been examined to date. Accordingly, in keeping with our priors, we expect that if an independent director is a member of the nomination committee, this will have a positive impact on the selection of independent directors.

Hypothesis 5a: *Companies with nominating committees containing independent members will be positively related to an increase in overall board independence.*

While diversity is of potential value, it is plausible that boards will face the same inclination as top management teams to reproduce themselves (Boone et al., 2004). Following the similarity–attraction paradigm (Byrne, 1971; Berscheid and Walster, 1978), closely tied groups tend to select new members who match the group culture and thus knowingly or unintentionally choose new members who are similar to themselves. The presence of a foreigner on a nomination committee may diminish such reproduction tendencies. This effect may be particularly notable in the selection of foreign nationals, where uncertainty will be highest, and thus an understanding of how foreign knowledge can be of use and may be integrated into the overall board will be essential. There is some empirical support for this argument. Research on group minorities has shown that a board committee member who represents a minority on the board will tend to favour new board members who are similar to him/her (Westphal and Milton, 2000). Therefore, we expect that if a nomination committee has a foreign member it is more likely to select new board members who are also foreign nationals.

Hypothesis 5b: *Companies with nominating committees containing foreign members will be positively associated with an increase in the number of foreign board members on the company board.*

Following the similarity/attraction paradigm (Byrne, 1971; Berscheid and Walster, 1978), we expect that the presence of a female nomination committee member will increase the level of female representation on the board as a whole.

Hypothesis 5c: *Companies with nominating committees containing female members will be positively associated with an increase in the number of females on the main company board.*

3. Methodology

3.1. SAMPLE AND RESEARCH CONTEXT

The sample of the study consists of all 269 companies that were listed on the SWX in September 2004. We subsequently excluded (1) investment trusts, (2) companies without websites and investor relations contacts, and (3) companies with no annual reports available to the public. This procedure generated a sample consisting of 210 companies. Data on board composition for the three years between January 2001 and December 2003 were obtained from companies' annual reports and websites. Ownership data were collected from the annual editions of the Swiss Stock Guide. Additional company level data were obtained from Thomson ONE Banker. This procedure resulted in 496 company year observations.

By law, Swiss companies need to establish one board (*Verwaltungsrat*), which needs to contain a representative of the company's executive management. However, many Swiss listed firms have adopted a two-tier board structure, somewhat similar to the German governance system, consisting of a management board (*Geschäftsleitung*) comprising inside directors only, and a supervisory board (*Verwaltungsrat*) consisting mainly of outside directors. The exception tends to be the CEO, who is often a member of both boards. However, CEO duality, where the CEO is also Chairman of the Board, is a much less frequently occurring phenomenon among Swiss firms than e.g. in the US (see below).

In July 2002, SWX introduced new guidelines applicable to all listed companies. These guidelines are similar, though somewhat less far reaching, than codes in e.g. the UK and the US. We analysed the situation in Switzerland immediately before and after the introduction of the new guidelines (the 18 months preceding and after the 18 months following July 2002).

3.2. VARIABLES AND MEASURES

3.2.1. *Board composition*

Board composition is measured as those directors in place at the end of a calendar year. In the rare case that board members were present on a board for less than one year and were no longer directors at a year-end reporting date, these board members would not appear in the board composition variables for this particular year. *Inside directors on board* is a count variable for the number of corporate directors who have an executive function with the company. Directors were defined as independent if they had no formal professional or personal relationship to the company over the past three years. Whereas previous research mostly uses a five-year period for definition of director independence (Pearce and Zahra, 1991; Daily and Dalton, 1994), our measure is based on the SWX guidelines that require companies to disclose directors' affiliations to the company for the last three years only. Drawing on prior studies (Kosnik, 1987) we defined several type of directors' affiliations. Directors who have served as inside directors of the firm during the last three years were coded as *former inside directors*. Individuals who were founders of the company or are members of the family of the founders were defined as having a *family affiliation*. If two directors served on the board of directors of another Swiss listed company during a particular year, we coded this connection as *interlocking directorship affiliation*. We only recorded cross-involvements in publicly listed companies in Switzerland and excluded cross-involvements in all other types of organisations such as not publicly listed companies, state and governmental institutions etc. Further, we created a *consulting affiliation* category which reflects any type of material business relationship between the director and the firm such as consulting or auditing services, legal advice etc. Our *other affiliation* measure includes cross-board involvements in publicly listed companies outside Switzerland and any other type of material connection to the company stated in the annual report that does not fit with any of the other affiliation variables as defined above. For all affiliation categories we used dummy variables equal to one if a director was affiliated to a company and zero otherwise. *Director independence* was also coded as a dummy variable that is equal to one if a director has zero values for all categories of company affiliations in a certain year and to zero otherwise. *Number of independent directors* is a count variable referring to the number of independent directors sitting on a board in a particular year. In line with the other work on board composition (Hermalin and Weisbach, 1988; Sanders and Carpenter, 1998), we are "counting" directors and use these counts in our variable construction. This has implications for modelling procedures as detailed below. *Director education* was coded along four main categories: business, law, technical education and others. *Director gender* and *director nationality* were recorded as stated in the company's annual report.

As our gender diversity measure, we used the *number of female directors* serving on a company's board. Similarly, our *number of foreign directors* variable is a count variable for foreigners representation on a board regardless of their nationality. In order to measure the degree of board diversity (*nationality diversity* and *educational diversity*), we calculated Blau's (1977) index, a measure of group heterogeneity which is commonly used in top management team and board research (Finkelstein and Hambrick, 1996; Carpenter, 2002).

$$B = \left[1 - \sum (p_i)^2\right]$$

where B is the heterogeneity measure and p is the percentage of board members in the ith group (i.e. nationality, education). The higher the value of B, the greater is the heterogeneity on a particular variable.

3.2.2. *CEO duality*

Consistent with most previous research on board – CEO dynamics (Daily and Dalton, 1994; Westphal and Zajac, 1995; Sanders and Carpenter, 1998), *CEO duality* was defined as a dummy variable equal to one if the CEO of a company also serves as Chairman of the board.

3.2.3. *Off-board shareholdings*

As a measure of ownership concentration, we used the percentage of equity held by the single largest (off-board) individual or institution. This measure was used previously by Conyon and Peck (1998).

3.2.4. *Nomination committee*

Firms were classified as having a nomination committee if their annual reports stated (in keeping with the requirements of the new SWX guidelines) that the task of a standing board committee included nominating new directors. This classification is less strict than that used by other researchers (e.g. Vafeas, 1999), who only counted a nomination committee if its sole function was to nominate new directors. Firms with a single committee in charge of board affairs were not counted as having a nomination committee. *Nomination committee existence* is defined as a dummy variable equal to one if the company reported the existence of a nomination committee and to zero otherwise. *Nomination committee size* is a count variable for the number of directors who were listed as members of the nomination committee in a company's annual report. *Independent director on the nomination committee* is a dummy variable which is equal to one if at least one member of the nomination committee is independent director and to zero otherwise. Similarly, *foreigner on the nomination committee* and *female director on the nomination committee* are dummy variables that equal to one if there is at least one foreigner or female director on the nomination committee and to zero otherwise.

3.2.5. *Change variables*

In order to investigate how the members of a nomination committee influence board composition we use variables that reflect the change in board characteristics. Similar to Westphal (1998), we created variables that capture the change in board characteristics from year to year. *Change in number of independent directors* was calculated as the difference in the number of independent directors serving on the board in a particular year compared with the year before. Similarly, *change in number of female directors* reflects the difference in the number of women directors between a particular and the previous year. *Change in number of foreigners* accounts for the difference in the number of foreign directors. In our models, the change variables are linked to a nomination committee's composition in the prior year in order to avoid double counting of directors who were recently selected to both the board of directors and the nomination committee.

3.2.6. *Control variables*

Boards need to be of a sufficient size in order to form sub-committees. Previous research shows that larger boards are more likely to adopt board committees (Vafeas, 1999; Carson, 2002). Furthermore, according to agency theory larger boards are less effective as there is room for free-riding (Jensen, 1993). Board size is also considered to be an important factor in the CEO–board relationship. Large boards were found to be less effective monitors, as they are more likely to be confronted with difference in opinions and are therefore less difficult for the CEO to dominate. Board size is also likely to affect the number of female, foreign and independent directors sitting on a board. As we use count variables for our measures of board composition we control for *board size* (the number of directors serving on the board) in all hypotheses on determinants and effects of nomination committees (H1–H4). We further controlled for *changes in board size* (difference in the number of directors between a particular year and the year before) in the models hypothesising changes in board composition (H5a–H5c).

Board and managerial ownership is an important internal corporate governance mechanism (Jensen, 1993), which can be seen as a substitute for forming board committees. Greater managerial ownership of the equity will reduce the latent agency problem by making management behave like shareholders (Jensen and Meckling, 1976). In accordance with theory, Kesner (1987) found that directors' stock ownership is positively related to organisational performance. We use the percentage of shares held by both the management and the board in order to control for *board/managerial ownership* effects on adoption of a nomination committee.

As this study uses a cross section of companies over time, we control for *year effects*. Furthermore, the introduction of the Corporate Governance guidelines by the SWX in July 2002 can be expected to have caused changes in board structure and composition. In order to discern effects resulting from the Corporate Governance guidelines we use a set of year dummy variables.

Since our sample consists of all companies listed on the SWX, it represents a wide range of industries. Theory suggests that industry shapes the composition of boards (Hambrick and Mason, 1984; Finkelstein and Hambrick, 1996). We therefore controlled for *industry effects* by using the first-digit of the primary SIC codes from Thomson One Banker.

3.3. DATA ANALYSIS

We used probit regression techniques to estimate the likelihood of certain factors to influence the existence of a nomination committee (H1a; H1b) which was defined as a discrete variable. The maximum likelihood (probit) estimation model was

$$\begin{aligned}\Pr(\text{NC existence} = 1) = \Phi(\alpha &+ \beta_1 \text{boardsize} + \beta_2 \text{CEO duality}\\ &+ \beta_3 \text{off-board shareholdings}\\ &+ \beta_4 \text{board/managerial ownership}\\ &+ \beta_5 \text{year} + \beta_6 \text{industry})\end{aligned}$$

where Φ is the cumulative normal distribution.

To test our hypotheses about the effects of nomination committees on board composition (H2a–H4b), we used Poisson and ordinary least squares

(OLS) regressions. Poisson regression is recommended where the dependent measures are non-negative count variables with a limited range, as count variables violate the assumptions of OLS regression. We used Poisson regression to test hypotheses H2a–H3b and OLS regression to test H4a and H4b, where the dependent variables are continuous. We modelled the effects of a nomination committee in the following way:

$$L(\beta) = \sum_{i=1}^{N} \sum_{t=1}^{T} [c_i - \exp\,(x_{it}\beta) + n_{it}x_{it}\beta]$$

where c is a constant that does not affect the maximisation process, n_{it} is the number of directors for firm i in year t, N is the number of firms and T is the number of time periods per firm.

For our final set of hypotheses linking the composition of a nomination committee to changes in board diversity and independence (H5a; H5b; H5c) we used OLS regressions based on the following model:

$$\Delta \mathrm{BC}_{it,t-1} = \alpha + \beta\ \mathrm{NCC}_{i,t-1} + \delta\ \Delta\ X_{it,t-1} + \Delta\varepsilon_i$$

where $\Delta \mathrm{BC}_i = \mathrm{BC}_{it} - \mathrm{BC}_{i,\ t-1}$ and $\Delta\varepsilon_i = \varepsilon_{it} - \varepsilon_{i,\ t-1,}$ BC being the composition of the board and NCC is the composition of the nomination committee. Estimating the model in first difference form sweeps out the firm-specific fixed effects from the model specification.

4. Results

Table I contains a summary of the descriptive statistics and the correlation coefficients for all variables for the entire period of the study (2001–2003). Forty one percent of the companies in our sample have a nomination committee. In only 22% of the observations the CEO also serves as the Chairman of the company. The largest off-board shareholder of companies listed on SWX holds on average 33.98% of the company shares. Swiss boards of publicly listed companies have an average size of 7.23 members of which on average 0.82 are inside directors, 3.71 are independent directors, 0.34 are women and 1.56 are foreigners. The development of board composition over time shows changes which are in compliance with the recommendation of the Corporate Governance directive of the SWX (2002). The percentage of companies with nomination committees has continuously risen from 35% in 2001 to 46% in 2003. Companies have also separated the positions of CEO and Chairman during this period and decreased the average number of inside directors serving on Swiss boards. The average number of independent directors has increased significantly from 0.63 in 2001 to 4.38 in 2003. Table II reports the characteristics of nomination committees of those

Table I. Descriptive Statistics: Means, Standard Deviations and Correlations [a]

Variable	2001–2003	1	2	3	4	5	6	7	8	9	10	11	12	13	14
1. Nomination committee (NC) existence	0.41 (0.49)	1.00													
2. Board size	7.23 (2.69)	0.31	1.00												
3. CEO duality	0.22 (0.42)	−0.04	−0.10	1.00											
4. Off-board shareholdings	33.98 23.68	−0.16	0.04	−0.08	1.00										
5. Number of inside directors on board	0.82 (0.86)	−0.15	−0.10	0.45	−0.09	1.00									
6. Number of independent directors	3.71 (2.91)	0.30	0.44	−0.15	−0.02	−0.30	1.00								
7. Number of female directors	0.34 (0.62)	0.15	0.45	−0.09	0.18	−0.21	0.22	1.00							
8. Number of foreign directors	1.56 (1.94)	0.15	0.21	0.21	−0.24	0.24	0.05	−0.07	1.00						
9. Board nationality diversity	0.27 (0.25)	0.13	0.00	0.20	−0.26	0.19	−0.05	−0.16	0.84	1.00					
10. Board educational diversity	0.53 (0.16)	0.04	0.27	−0.07	−0.02	−0.03	0.15	0.13	−0.10	−0.15	1.00				
11. NC size	1.37 (1.77)	0.93	0.38	−0.01	−0.17	−0.11	0.28	0.17	0.23	0.16	0.05	1.00			
12. Independent director on the NC	0.33 (0.47)	0.87	0.21	−0.09	−0.17	−0.19	0.47	0.12	0.10	0.08	0.01	0.79	1.00		
13. Foreigner on the NC	0.19 (0.39)	0.55	0.11	0.07	−0.23	0.00	0.13	0.00	0.43	0.45	−0.08	0.58	0.50	1.00	
14. Female director on the NC	0.05 (0.23)	0.28	0.09	−0.04	0.07	−0.13	0.07	0.31	−0.07	−0.08	0.10	0.25	0.25	0.08	1.00

[a]Standard deviations are in parentheses.
$n = 496$.

Table II. Nomination committee characteristics

Variable	2001			2002			2003		
	a	*b*	*c*	*a*	*b*	*c*	*a*	*b*	*c*
Nomination committee existence	85	0.35	(0.48)	204	0.38	(0.49)	207	0.46	(0.50)
Nomination committee size	30	3.53	(1.07)	78	3.35	(1.03)	95	3.29	(1.01)
Independent directors on companies' nomination committees	30	0.73	(1.26)	78	1.96	(1.14)	95	2.12	(1.11)
Number of companies with at least one foreign director on company' nomination committees	30	0.53	(0.50)	78	0.46	(0.50)	95	0.46	0.50
Number of companies with at least one female director on company' nomination committees	30	0.13	(0.35)	78	0.13	(0.34)	95	0.14	(0.35)

a, number of observations.
b, mean.
c, standard deviation.

companies with them in our sample over the entire period of the study. In terms of nomination committee composition, 78% of all companies have at least one independent director on their committee and the committees have become more dominated by independent directors: companies had on average 0.73 independent nomination committee members in 2001, 1.96 independent committee members in 2002 and 2.12 independent committee members in 2003. Thirteen percent of all companies with a nominating committee have a female member and around half of companies with one have at least one foreign director as a member. At the same time, the average board size has remained stable throughout the period at around seven members.

Table III presents the results for our tests of nomination committee determinants and effects. Column 1 reports the results from the probit regression with nomination committee existence as a dependent variable. Columns 2–7 show the results from the Poisson and the OLS regressions, where nomination committee existence is a predictor of board independence and demographic characteristics. Our hypothesis 1a suggests that CEO duality decreases the likelihood of a company to adopt a nomination committee. There is some support ($p < 0.10$) for the hypothesised relationship. Further, our results supported hypothesis 1b stating that ownership concentration is negatively related to nomination committee existence.

Hypotheses 2a and 2b suggest that a nomination committee will enhance board independence. Our results are in line with the hypothesised

Table III. Determinants and effects of nomination committees

Predictors	Dependent variables						
	Nomination committee existence[a]	Number of insiders on board[b]	Number of independent directors[b]	Number of female directors[b]	Number of foreign directors[b]	Board nationality diversity[c]	Board educational diversity[c]
Nomination committee existence		−0.237† (0.124)	0.172** (0.055)	0.143 (0.192)	0.263** (0.086)	0.079** (0.025)	−0.016 (0.016)
Board size	0.071*** (0.013)	0.029 (0.024)	0.111*** (0.010)	0.199*** (0.035)	0.112*** (0.016)	0.002 (0.005)	0.019*** (0.003)
CEO duality	−0.133† (0.072)	0.788*** (0.110)	−0.132† (0.069)	−0.269 (0.271)	0.377*** (0.089)	0.079** (0.027)	−0.007 (0.018)
Off-board shareholdings	−0.004** (0.001)	−0.001 (0.002)	−0.002* (0.001)	0.007† (0.004)	−0.012*** (0.002)	−0.002*** (0.000)	0.000 (0.000)
Board/management ownership	−0.002 (0.002)						
Year 2002	0.116 (0.112)	−0.179 (0.142)	1.286*** (0.114)	−0.120 (0.234)	0.038 (0.115)	−0.007 (0.032)	0.008 (0.021)
Year 2003	0.186† (0.107)	−0.171 (0.143)	1.344*** (0.114)	−0.218 (0.241)	0.088 (0.114)	−0.001 (0.033)	0.010 (0.022)
Industry controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Log-likelihood	−200.696	−469.416	−929.565	−244.135	−726.738		
Chi^2	60.29	119.78	412.97	140.05	230.28		
R^2						0.176	0.158
N	337	448	448	448	448	445	428

[a]Probit regression.
[b]Poisson regression.
[c]OLS regression.
Huber heteroscedastic robust standard errors in parentheses.
†$p < 0.10$; *$p < 0.05$; **$p < 0.01$; ***$p < 0.001$.

relationships. Nomination committee existence is negatively associated with the number of inside directors ($p < 0.10$) and positively related to the number of independent directors serving on the board. We controlled for corporate governance mechanisms and found that CEO duality has significant effects in the expected direction. Further, the time effects were found to be significantly related to the number of independent board members. These findings suggest that the introduction of the Corporate Governance directive had an immediate effect on board independence.

No support was found for H3b, which suggested that nomination committees have positive effects on the number of female directors. However, board size and ownership concentration ($p < 0.10$) were found to be associated with the number of women serving on Swiss corporate boards. Consistent with H3a and H4a, the existence of a nomination committee was found to be positively related to both the number of foreign directors serving on the board and the degree of nationality diversity of the board. Our hypothesis 4b suggested that a nomination committee is positively associated with the degree of board educational diversity. The results, however, did not support this.

Table IV reports the results from regressions linking the composition of a nomination committee to its effects on changes in board composition. Our hypothesis 5a states that a nomination committee with at least one independent member is more likely to be associated with a positive change (an increase) in the board independence ratio. The results are in line with the hypothesised relationship. The regression results also confirm our hypothesis 5b which suggests that a foreign director's presence on a nomination committee is likely to lead to an increase in the overall representation of foreigners on the board. However, our hypothesis that a female member of a nomination committee will trigger a positive change in the representation of women on the board (H5c) found no empirical support. The coefficients for our control variable change in board size are positive and significant for all three hypotheses.

5. Discussion

Corporate governance researchers have recently been encouraged to address board sub-committees in order to capture critical processes and decisions (Dalton et al., 1998). Our results suggest that it matters whether companies have a nomination committee or not, and who are on such committees.

The central tenet of this article is that understanding different board roles and composition requires a multi-theoretical approach. Our findings support the view that agency theory, resource-dependence theory and group

Table IV. Effects of nomination committees' composition on changes in board composition

Predictors	Dependent variables		
	Change in number of independent directors	Change in number of foreign directors	Change in number of female directors
Independent director on the nomination committee	0.742** (0.228)		
Foreign director on the nomination committee		0.252** (0.086)	
Female director on the nomination committee			−0.110 (0.073)
Change in board size	0.242** (0.087)	0.229*** (0.027)	0.064*** (0.013)
CEO duality	−0.438† (0.242)	0.000 (0.076)	0.013 (0.034)
Off-board shareholdings	0.001 (0.004)	−0.000 (0.001)	0.000 (0.001)
Year 2002	2.727*** (0.300)	0.054 (0.092)	0.005 (0.042)
Year 2003	−0.366 (0.305)	−0.033 (0.092)	0.012 (0.042)
Industry controls	Yes	Yes	Yes
R^2	0.383	0.169	0.082

$n = 430$.
Huber heteroscedastic robust standard errors in parentheses.
†$p < 0.10$; *$p < 0.05$; **$p < 0.01$; ***$p < 0.001$.

effectiveness theory help to explain different aspects of board composition and behaviour.

Our results on the control and monitoring mechanisms of boards and nomination committees appear to be largely consistent with the agency theory perspective. Throughout the period of our study, a steady decrease of CEO duality and the number of inside directors was observed while there was a remarkable increase in the number of independent directors. The fact that in a non-Anglo-American context such as Switzerland, characterised by a high degree of ownership concentration rather than dispersed ownership (La Porta et al., 1999), the link between a nomination committee's existence and board independence is in line with agency theory, suggests that its predictions can hold in a different institutional context.

Further, we found some support for resource-dependence theory (Pfeffer and Salancik, 1978) In our sample, boards with nomination committees had more foreign directors as well as a higher degree of nationality diversity. In addition, the presence of a large off-board shareholder had negative effects on both measures of board internationalisation. This result suggests that firms with dispersed ownership are more likely to hire foreign directors, which is in line with our argument that the internationalisation of financial markets urges firms to align the composition of their boards to the expectation of international shareholders.

Counter-intuitive insights emerge from our findings about nomination committee's influence on board diversity. Whereas diversity would represent a positive resource in the boardroom (Finkelstein and Hambrick, 1996; Forbes and Milliken, 1999), we found that nomination committees have no uniform effect on different types of board diversity. While on the one hand firms with nomination committees have a higher degree of board nationality diversity, on the other hand we found that firms with nomination committees are not more likely to have an increase in board gender and education diversity.

We believe that our results regarding board diversity should not be interpreted in an isolated manner. Increasing board diversity along a number of dimensions leads to a broader knowledge base and variety of perspectives but also to a higher degree of complexity. At the same time, there are institutional and economic restrictions to increasing diversity and degrees of complexity: increasing diversity along one dimension may put additional pressures or even go at the expense of other dimensions of diversity. In striving for best possible board composition, nomination committees will consider different dimensions of diversity *simultaneously*. One explanation for our findings is that if board diversity and hence complexity increases along one dimension, nomination committees will be exposed to pressures to counter-balance and thus reduce complexity along less critical diversity dimensions.

Support for this line of reasoning can be found in an emerging trend in diversity research. A major criticism of previous diversity research is that even though empirical studies include a number of diversity aspects, they study their effects independent from each other (Jackson et al., 2003). As diversity is a multi-dimensional phenomenon, diversity studies should reflect the interconnections between the different dimensions of diversity. In their recent review of upper echelons research, Carpenter et al. (2004) point at the need to regard directors as a "bundle" of attributes and study the interaction between the various dimensions of their personalities. An understanding of the interplay between the various diversity dimensions in a boardroom can help to better understand their combined and cumulative effects on organisational outcomes. Insights from Hillman et al. (2002) encourage further inquiries into the simultaneous consideration of multiple aspects of directors' personalities and the resulting in-depth understanding of board diversity as a multi-dimensional phenomenon. A fruitful research direction emerges from the notion of interconnectedness among different dimensions of diversity in a boardroom. By reviewing and synthesising existing board demographics research, scholars could identify the aspects of diversity which are particularly important for boards and study on the one hand the effects of nomination committees on diversity as a multi-dimensional phenomenon and on the other hand, the cumulative effects of the multiple diversity dimensions on board processes and performance. Whereas creating a multi-dimensional measure and understanding of diversity is a challenging task, it is a way to better understand the individual contributions that directors make as well as the benefits of boardroom diversity.

A limitation of our study is that we do not scrutinise the actual process of director selection and as a result a few important questions remain unanswered. We do not know what the actual criteria for director selections are and what their relative importance is. We study the existence of a board sub-committee with responsibilities for director nominations, but we are unable to explore how the actual working practices of nomination committees differ. Yet, the effects of a nomination committee will, to an extent, be determined by the time and commitment of committee members and by the professionalisation of the process of director selection. Has the process of director selection changed and become more professional after the introduction of a nomination committee or is it still the same but just delegated to a smaller group of directors? To what degree is the CEO involved in the nomination of new directors? In the case of a joint remuneration and nomination committee, to what extent are committee members dealing with nomination issues and to what extent are they concerned with more pressing issues such as remuneration? There is a continuing need for a more in-depth understanding of the actual work and behaviour of corporate directors (Huse, 2005). In future research, it will be necessary to examine nomination committees more closely and over a longer time horizon in order to assess the extent to which their role is actual and relevant in a professional board.

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