

Corporate Governance Special Issue — 2004



Point of View

PERSPECTIVES ON LEADERSHIP

SpencerStuart

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Every major economy has been through a period of self-examination, resulting in either new legislation or the publication of a best practice code. To help prospective non-executives contemplating a directorship on a foreign board understand the often subtle differences in governance from one country to the next, we've provided a high-level overview of corporate governance practices around the world.

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Mutual fund boards now face an unprecedented degree of scrutiny from regulators, legislators and investors, who are demanding that mutual fund boards become more involved and more accountable. But with the forces for reform now in motion, independent directors can and should seize the opportunity to improve corporate governance, pushing the board to become more independent and effective as a result.

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The corporate governance spotlight that has shone brightly on public companies now is beginning to illuminate nonprofit boards. Today, we are witnessing more nonprofit boards embrace the same governance practices as public companies — with many examining current and potential directors to make certain the necessary professional and business skills are at the table.

Over the past few years, corporate governance has emerged as a topic being debated in boardrooms around the world. Our counsel on key governance issues has continually been sought by chairmen, CEOs and nominating committees — be it for a multinational corporation or a nonprofit organization.

For more than 20 years, Spencer Stuart has examined the latest issues and trends on the governance matters that are critical to running effective organizations. Spurred on by questions from our clients and our experiences in this arena, we have again assembled our latest collective knowledge on corporate governance for this special issue of *Point of View*.

As always, we welcome your questions and comments.

David S. Daniel

chief executive officer

Spencer Stuart

A director's guide to corporate governance around the world

David Kimbell, *Spencer Stuart — London*

Henri de Pitray, *Spencer Stuart — Paris*

As recently as 15 years ago, the study of corporate governance mostly was confined to academia and a relatively small group of institutional investors concerned with scrutinizing systems of control in the larger listed companies.

Over the past decade or so, the governance landscape has changed beyond recognition. Every major economy has been through a period of self-examination, resulting in either new legislation or the publication of a best practice code. Some countries have been set on a steady course of reform, whereas others essentially have reacted to events. Wherever you look, corporate governance is a moveable feast — that is partly its fascination.

A single model of good corporate governance clearly is out of the question, nor will there ever be one type of universally acceptable board structure. Nevertheless, much has been written about the convergence of governance models around the world, and there is plenty of evidence that many best practice codes have developed along overlapping lines.

However, the differences in governance from one country to the next remain substantial enough to perplex all but the most diligent observer. Prospective non-executives contemplating a directorship on a foreign board need to understand the often subtle differences in governance from one country to the next. The same is true of directors serving on the board of a company subject to the rules of a foreign stock exchange, and for directors of companies with significant international revenue or M&A interests.

Legislation versus “comply or explain”

The semantics of corporate governance would make an interesting study. A surprising number of terms are employed to describe the officially sanctioned line on governance behaviour from country to country: they are referred to variously as codes, guidelines, principles, recommendations, policies, regulations and rules. Each implies subtly different things and it is not unusual to find several terms used in a single document. This can lead to confusion over what exactly is the precise nature or enforceability of each code or set of guidelines, etc.

On the whole, corporate governance behaviour is governed by one of two approaches: legislation, where governance behaviours are defined by statute and action can be taken through the courts to penalize non-compliance; and the principle of “comply or explain,” in which companies are obliged to disclose the extent of their compliance with a voluntary code of practice and account for any deviations, leaving the market to decide.

Whereas the U.S. has adopted a mainly legislative approach to corporate governance, most other countries take a generally less prescriptive approach. There is no specific code of governance in the U.S. As the Sarbanes-Oxley Act demonstrates, when the bar is raised, it is not in small measures. By contrast, the 2003 *Combined Code* in the U.K. is the culmination of no fewer than seven reports/codes issued by government-sponsored committees over an 11-year period, which have resulted in steady, incremental changes to governance practice and boardroom behaviour.

The truth is that outside the U.S. many of the fundamental governance imperatives, particularly in the area of disclosure, are neither voluntary nor a matter of “comply or explain” — they are covered by stock exchange listing requirements and are, therefore, mandatory. This effectively amounts to legislation by the back door. For example, in Australia, there is no law requiring a company to have an audit committee, yet the ASX listing rules make one compulsory. A more extreme example can be found in non-U.S. companies listed on the New York Stock Exchange (NYSE) that find themselves subject to the law of another country

(Sarbanes-Oxley), which de facto takes precedence over any domestic governance code or best practice recommendations.

Board structure

Variations in board structure from country to country account for many differences in governance practice. The unitary board structure prevails in most countries — that is to say, a single board comprising non-executive directors with some executive representation. Within these countries there are many variations. For example, in the U.K., the roles of chairman and CEO typically are separated, whereas in the U.S. they normally are combined. In Italy, where a pyramidal group structure means that the separation between ownership and control often is ambiguous, the main board (*consiglio di amministrazione*) is supplemented by a board of auditors (*collegio sindacale*), which is elected by shareholders.

In France, a company may choose between three different board structures, depending on which one enables it “to carry out its mission in the best possible manner.” The single-tier board (*conseil d’administration*) is the most common and has two manifestations: one with a combined chairman/chief executive and one where the roles are separated. In addition, some companies adopt a two-tier structure with a supervisory board (*conseil de surveillance*) and a management board (*directoire*).

In Germany, the two-tier (or dual) board system is prescribed by law. A separate management board (*Vorstand*) and supervisory board (*Aufsichtsrat*) are mandatory for all companies that issue shares and for large limited liability companies. The supervisory board is made up exclusively of non-executive directors, of which a percentage must be employee representatives (50 percent in companies with more than 2,000 employees).

Non-executive directors

Different codes of governance treat non-executive directors in different ways, for example, in terms of the role and composition of the board and its committees, expectations of independence, the nominations process and compensation.

In the case of committee membership, there is clear evidence of convergence among codes. The trend is for most committees to be composed entirely of non-executive directors, and in the case of audit committees, the majority (if not all) should be independent directors.

The importance of the nominating committee has grown around the world as the spotlight falls on board composition and director independence. Many codes now explicitly state that the committee will preside over a formal, rigorous and transparent procedure for the recruitment of new directors. In most countries, the committee's role also has broadened to include responsibility for succession planning and, in the case of the U.S. and Canada, the supervision of governance issues.

One of the most interesting aspects of the rise of the numerous national governance codes is the myriad interpretations given to the notion of "independence." Generally considered to be the *sine qua non* of good governance, independence has become the subject of intense debate. Those on the side of prescription argue that the only really effective way to ensure independent, objective thinking in the boardroom is to outlaw a detailed list of relationships and activities for non-executive directors. Others emphasize that independence ultimately is an intellectual state of mind, and the tendency towards box ticking is not only futile but also counterproductive.

What is certain is that there are as many definitions of independence as there are countries. There are many common threads, such as not having been employed by the company in an executive capacity or as a professional adviser for a given period of time (usually between three and five years); not having close family ties with company advisers or senior employees; and not having an important business relationship with the company, such as being a significant supplier, customer or shareholder. However, most country definitions include unique elements which can, in part, be explained by local circumstances. So, for example, in Canada the proposed listing rules on independent audit committee members are extremely detailed; by contrast in Switzerland, where the pool of non-executive

directors is considered limited, “reasonable application” of the independence criteria is left to companies themselves. In the U.S., directors receiving more than \$100,000 per year in direct compensation cannot be considered independent until three years after such compensation ended; in France, a director loses independent status after serving 12 years on the board. For directors serving on boards in different countries, navigating all the definitions of independence is not a simple task.

Corporate governance is set to remain at the top of the agenda for boards, investors and the media for some time to come. As Spencer Stuart continues to place independent directors into board roles around the world and be involved in board assessments, we will be maintaining a close eye on developments in governance theory and practice, particularly as these developments affect individual directors.

About the authors

David Kimbell has been a consultant with Spencer Stuart since 1979 and co-leads the European Board Services Practice with Henri de Pitray, who focuses on board-level searches across a large variety of sectors for major French and international groups.

Rules of engagement: How boards are recruiting and retaining today's directors

Tom Neff, *Spencer Stuart* — *New York*

In the post Sarbanes-Oxley world, boards continue to struggle with the delicate balance of supply and demand for good board directors. In a perverse way, the reforms may be triggering a boardroom crisis that could seriously weaken rather than strengthen corporate governance. First and foremost, demand for quality board directors is skyrocketing. Boards need directors who not only fit the new definition of independence, but who also are both qualified and willing to sit on the audit and/or compensation committees. And due to the increased time demands of board and committee work and scheduling issues, it is difficult, in many cases, for an independent director to sit on more than one committee. Given that boards now need a greater number of independent directors to serve on critical committees, it is not surprising that the overall size of some boards will have to increase, reversing a trend we have observed over the last 10 years. Yet, as the demand for directors grows, the pool of qualified candidates continues to dwindle for a variety of reasons.

Some director candidates are increasingly wary of committing to new boards — never mind agreeing to stay on current ones. The increased workload and exposure to financial, reputational and personal risks are causing many experienced directors to rethink their involvement and conclude it's not worth it. Given these challenges, boards are proactively working to strike the right balance and mix of directors over the long term. These shifts are forcing boards to be more flexible and willing to rethink not only who their ideal candidate is, but also how they can attract and retain a new breed of director. There is now more receptivity to considering high-potential individuals with no prior corporate board experience.

Over the last year, through our more than 300 board director searches conducted in North America, we have observed a number of key measures that boards are beginning to adopt in order to recruit and/or retain directors in this new and uncharted territory.

Considering recently retired executives

Big company boards traditionally have sought out high-profile and active CEOs as independent directors. But with more and more CEOs and other senior-level executives finding directorships less attractive, coupled with either pressure or restrictions from their own companies to sit on fewer boards, the number of available CEOs is dropping. In 2002, only 32 percent of new directors fell into the active chairman/president/CEO category, a nine-point drop from the previous year, according to the 2003 *Spencer Stuart Board Index*. We expect to see this trend continue in our 2004 index. Active executives are just more reluctant to take on time-consuming boards and, in some cases, are quietly exiting board seats they currently occupy.

And while active executives always will be an attractive talent pool, boards today are much more willing to consider recently retired executives for new openings — a big change from less than two years ago. Retired executives possess comparable experience and knowledge and, most importantly, they have more control over their available time and are more willing to take on a challenging board assignment. In fact, according to our 2003 board study, retired chairmen, presidents, CEOs and COOs represent 12 percent of new outside directors, compared to only six percent in 1998, and this trend has continued over the last year. Case in point, we were not surprised when the board of Coca-Cola announced that Donald Keough, former president and COO of the company, was returning to the board. At the age of 77, Keough not only brings 50 years worth of knowledge and experience of the food and beverage industry to the company, but he also has the passion and, apparently, the time to commit.

Adding financial expertise

In spite of significant progress, the search for financial skills remains critical for boards and we see no end in sight. Sarbanes-Oxley requires the audit committees of all publicly listed companies to have at least one financial expert by the end of this year — and if not, explain the reasoning. Many boards are looking at recently retired CFOs of larger companies. These executives, with their strong financial backgrounds and boardroom exposure, are immediately earmarked for the audit committee.

Boards also want expertise in control and accounting issues. It is not surprising that while corporate experience is preferred, boards today are much more open to recruiting retired senior audit partners who have either held a management position or bring strong industry experience. Royal Caribbean Cruises required a director who met the “financial expert” requirements of Sarbanes-Oxley. The board’s nominating committee immediately was drawn to William Kimsey. As the former CEO of Ernst & Young, Kimsey brought a wealth of both financial expertise and high-level strategic understanding to the boardroom.

Based on informal discussions with our clients, we expect that the demand for financial expertise will be an ongoing requirement. Some directors will want to rotate off of the audit committee due to the ever-increasing workload, which means that well-prepared boards will want to have several financial experts — not just one — as part of their bench strength. General Mills, Deere & Co., Comverse Technology, Cincinnati Financial and Ashland are examples of boards that recently have added financial experts available to serve on the audit committee.

Increasing board compensation

Compensation is not normally a primary motivating factor for joining a board. More important are the company’s reputation, confidence in the CEO, ease of location, meeting frequency and overall time demands. However, board compensation can be a concern when recruiting directors if it lags behind what other boards pay. The average annual board retainer based on our analysis of 2003 proxies of larger companies increased about 10 percent to \$44,000.

This is only the beginning — last year, the percentage increased another 13 percent. Over the last six to 12 months, many of our clients have been asking for more information about how other companies are handling director compensation. They are telling us that they expect their boards will be reviewing and readjusting compensation to be in line with market trends.

With more boards beginning to address compensation in response to the added time requirements of board service, we predict the numbers will reflect, in some cases, significant increases in compensation — as much as 50 percent — even as other boards adopt a wait-and-see approach to observe what others have done.

Extending mandatory retirement age

We are witnessing firsthand that it is taking boards nearly twice the amount of time to identify and recruit directors than it had in the past. To manage this extended timeframe, many boards are reexamining their mandatory retirement age in an effort to avoid losing good directors who are both willing and able to continue serving. On average, of those boards that have a mandatory retirement age, we are seeing an increase from 70 to 72 — and even higher in other cases. Deere recently voted to move its mandatory retirement age for independent directors from 70 to 71. This shift provides boards more time to look for replacement directors without sacrificing its overall quality and productivity.

Conclusion

It is still too soon to tell if the criticisms associated with Sarbanes-Oxley ultimately will outweigh the benefits. What is clear is that boards are delving much more deeply into company issues, challenging management more aggressively and spending more time on board-related matters. And because the demand for qualified and willing directors currently is greater than the pool of available talent needed to achieve these new objectives, boards have no choice but to address the challenges of recruiting directors by looking at alternative solutions.

As competition for director talent heats up, progressive boards are dealing with the recruiting issue by considering recently retired executives, fortifying bench talent for the audit committee, reexamining the appropriate level of board director compensation and increasing or dropping the mandatory retirement age.

About the author

Tom Neff has been with Spencer Stuart since 1976, managing the worldwide firm from 1979 to 1987 and establishing the Board Services Practice in the U.S. in the early 1980s.

Rising expectations: Mutual fund directors called to create a culture of independence

Julie Hembrock Daum, *Spencer Stuart* — *New York*

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A profound change in the way mutual fund governance is viewed is rippling through the industry, set off by revelations of abuses involving market-timing and late-trading, as well as by greater awareness of the sometimes high undisclosed costs borne by shareholders.

Much like the corporate scandals that led to the passage of the Sarbanes-Oxley Act and the creation of a slew of new requirements by the Securities and Exchange Commission (SEC) and the stock exchanges, these revelations have provoked outrage and stoked a groundswell of calls for mutual fund governance reform. Industry critics call the abuses a betrayal of trust and fiduciary responsibility, and accuse mutual fund boards of displaying a tameness toward management exceeding even that of corporate boards. Only a dramatic change in the culture of the industry and a meaningful improvement in the effectiveness and independence of mutual fund boards, they say, will halt abuses and rein in fees.

In short, mutual fund boards have been put on notice. They now face an unprecedented degree of scrutiny from regulators, legislators and investors, who are demanding that mutual fund boards become more involved and more accountable. Increasingly, boards are expected to ask more questions, have resources to independently measure the performance of the management company, and challenge fund management when it raises proposals that might run counter to the best interests of shareholders.

SEC Chairman William H. Donaldson underscored the new expectations of fund boards, and independent

directors in particular, during a January 2004 Mutual Fund Directors Forum: “You are the investors’ first line of defense in ensuring that their interests are being served, that conflicts of interest are appropriately managed and disclosed, and that investors’ money is being managed responsibly. While the SEC shares this mission to protect investors, we cannot be in the boardroom when investors’ interests may be compromised. Investors are depending on you to stand up for them.”

Some independent directors may feel uncomfortable with this growing set of expectations and new level of accountability. But with the forces for reform now in motion, independent directors can and should seize the opportunity to improve governance, pushing the board to become more independent and effective as a result.

Renewed focus on governance

Mutual funds have become a primary investment vehicle for millions of American families, especially for retirement and college tuition savings. Some 90 million Americans have invested more than \$7 trillion in mutual funds. According to the SEC, by the end of 2002, mutual funds were entrusted with approximately 21 percent of the \$10.2 trillion U.S. retirement market and 98 percent of the \$18.5 billion placed in Section 529 college saving plans.

Well before mutual funds became such an important avenue for investment, the U.S. Congress recognized the potential for abuse and conflict of interest inherent in investment companies. The Investment Company Act of 1940 established specific requirements for board independence and assigned unique oversight responsibilities to the board, including approving the fund’s contract with the investment adviser, valuing certain securities held by the fund, approving the management company’s advisory fee, and monitoring and protecting against conflicts of interest.

Critics charge that, despite this congressionally mandated “watchdog” role, trustees have acquiesced too readily to the demands of fund management companies, failing to protect investors from conflicts of interest, question excessive fees or halt ethical breaches such as short-term trading or

illegal activities such as late-trading. The SEC has announced disciplinary actions or settlements against more than two dozen companies for those activities and others that harm long-term fund investors. And in case any mutual fund trustee remained complacent in the face of these developments, the SEC and New York Attorney General Eliot Spitzer forced out eight of the directors of one troubled fund as part of a civil-fraud settlement agreement, alleging that the board failed to look out for the best interests of long-term fund shareholders.

In addition to the stepped-up enforcement efforts, regulators and legislators have responded to these scandals with calls for new regulations aimed at increasing fund transparency and enhancing the effectiveness and independence of mutual fund boards. The U.S. House Financial Services Committee, for instance, has approved an amendment that would require mutual fund boards to select a “lead independent director,” who would have the authority to place items on the agenda, call meetings and obtain outside advice on behalf of the independent directors. And, in June, the SEC formally adopted a number of new governance requirements, which:

- > Increase the percentage of independent directors to 75 percent (from 40 percent) and name an independent chairman
- > Require separate meetings of the independent directors at least once a quarter
- > Provide for independent director staff
- > Require an annual self-assessment

It's not just legislators and regulators who are pushing governance reform. Joining the growing chorus for reform are some of the largest pension funds. The California State Teachers' Retirement System recently adopted a new set of disclosure and independence standards that mutual funds must meet to receive investments from the pension plan. Other public pension funds are considering similar measures. Some large investors are going even further, calling on mutual fund directors to “fire” the management companies of poorly performing or poorly managed funds. While many in the industry view this approach — which,

like an endowment or pension fund, treats the management company as a vendor — as an excessive remedy absent evidence of significant mismanagement or misappropriation, it underscores the growing demands for governance reform facing mutual fund directors.

Creating a culture of independence

Even as the discussions about new regulations continue, independent directors have the opportunity to take the lead in improving board governance by ensuring that the board truly is independent and qualified, and by increasing the transparency of the nominating process. First and foremost, the independent trustees need to take responsibility for nominating directors.

Like their corporate counterparts, many mutual fund boards have relied on the recommendations of management to fill board vacancies, even for independent directors. Sarbanes-Oxley, for example, addresses this concern, requiring corporate boards to establish a nominating committee of independent directors. Mutual fund boards can demonstrate their independence by doing the same. Already, we have seen movement in that direction as, increasingly, mutual fund director searches are originating with the boards, themselves, rather than the fund companies.

Nominating committees also need to have the resources to identify and attract the right trustees. Up until now, few mutual fund boards had their own staff or the resources to hire outside consultants, and had to rely on the fund management company for information and analysis. Regulators have recognized that this, too, must change if mutual fund boards are going to be as independent and effective as they need to be to safeguard investors' money. Recognizing this need, the SEC's proposed rules include a requirement that the fund authorize independent directors to hire their own staff to deal with matters on which they need outside assistance.

Finally, directors need to give careful consideration to the types of skills and expertise that the board should include. Along with a lack of independence, mutual fund boards have been criticized for lacking the financial and

investment expertise to question the decisions and practices of mutual fund management. Directors need to be knowledgeable enough to assess how fund managers are performing, whether management fees are appropriate and what risk and compliance issues the funds face. Each board should establish minimum standards for the skills it should possess collectively. These could include investment management experience, financial expertise, and knowledge of risk analysis and investment law. The board can use its annual self-evaluation, which would be required by the SEC's new rules, to continually review its composition and independence.

Where can individuals with the necessary skills be found? We believe that many highly qualified and independent candidates are available and willing to serve on mutual fund boards. Among the possibilities are retirees from mutual fund companies and investment companies, members of endowment, pension and foundation funds or their boards, institutional investors, academics in the area of finance, and attorneys who specialize in investment law. As fund boards assume more responsibility and independence, the pool of qualified candidates will continue to grow and boards are more likely to attract knowledgeable and effective professionals.

Conclusion

While many observers now argue that greater due diligence on the part of mutual fund boards may have prevented some of the worst of the abuses that have been revealed recently, it wasn't long ago that some voices in the debate about mutual fund governance questioned the need at all for oversight by a fund board. After all, the argument went, mutual fund customers always could "vote with their feet" and leave underperforming or poorly managed funds, and effective regulation would prevent abuses. Many would consider that a naïve view today.

Mutual fund industry misdeeds have shaken confidence in the industry, one that millions of Americans are relying on to fund their retirement and their children's education, and drawing renewed attention from regulators and legislators. Mutual fund boards — and independent directors, in par-

ticular — can take the lead in improving board governance by ensuring that the board is truly independent and qualified, and by increasing the transparency of the nominating process. To do this, boards need to take responsibility for nominating directors and establish standards for the collective knowledge and expertise directors must possess. Fortunately, we believe many highly qualified individuals will welcome the opportunity to join more independent and effective mutual fund boards.

By increasing the transparency of the nomination process so that investors can be confident that directors are not beholden to anyone and are free to make decisions in their best interest, mutual fund boards will go a long way toward rebuilding investor confidence.

About the authors

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“The main thing board evaluations achieve is to stop the board mumbling and allow it to surface issues in a very transparent way.”

Taking a closer look: The board evaluation

Susan Boren, *Spencer Stuart — Minneapolis/St. Paul*

Carolyn Eadie, *Spencer Stuart — London*

Amid the corporate scandals and subsequent reform initiatives of the past few years, the board of directors has emerged as both a target of blame for corporate misdeeds and the source of hope for better governance in the future.

Today, corporate directors are called to be more engaged, more accountable and more effective than in the past. But what are the characteristics of an effective board and how do boards ensure that they are performing at their highest levels?

Our experience working with corporate boards around the world tells us that an effective board brings a diversity of perspectives and necessary skills, focuses on strategic issues, is well-informed about the internal and external factors that impact the organization, and provides candid and constructive feedback to management. In addition, high-performing boards have committees with well-defined responsibilities, plan for board and management succession, and hold management accountable for performance.

As they strive to achieve these characteristics of a high-performing board, one of the most important tools they can draw upon is the annual evaluation. When done effectively, board evaluations provide a forum for directors to review and reinforce appropriate board and management roles and ensure that issues brewing below the surface are addressed promptly. In short, evaluations give the board an opportunity to identify and remove obstacles to better performance and to highlight what works well. So important are board evaluations that they have become not only a corporate governance best practice, but also are requirements of the New York Stock Exchange and the *Combined Code* in the U.K.

According to one senior independent director of a FTSE 150 company, “The main thing board evaluations achieve is to stop the board mumbling and allow it to surface issues in a very transparent way.”

For some companies, board evaluations are being placed on the agenda for the first time in response to the new requirements. Other companies — often longtime leaders in good governance — have conducted board evaluations for years, finding that thoughtfully planned and executed evaluations benefit them in large and small ways.

Throughout our years of facilitating board evaluations for clients, we have seen the process uncover a variety of issues and obstacles to better board performance. These range from easily addressed operational complaints about meeting length or the composition of the agenda, to larger, thornier issues concerning the board’s role in strategic decision-making, gaps in knowledge and competencies on the board, and executive and director succession planning. The corrective actions range as well — from improving the timeliness of board materials and winnowing overly long agendas, to making changes in the composition and, occasionally, the leadership of the board.

“If everything is going swimmingly, of course, boards are more relaxed and comfortable. If not, boards often want to get in and do something about it. That’s why it’s appropriate to do an evaluation every year,” observes John Rollwagen, chairman of the board of international reinsurance group PartnerRe and an independent director for two other companies.

We recommend that each year boards conduct a broad review of their organization, agendas, meetings, bylaws, committees, communication, board materials and their performance of responsibilities such as managing the CEO relationship, strategic planning, management and board succession, governance and financial oversight.

Through the evaluation process, some boards find that they generally are satisfied with the overall board charters and membership, but express frustration at the quantity or timeliness of information they receive from management.

In our work, for example, we commonly hear from directors that agendas focus too narrowly on financials or are too long for the given meeting time, leaving too little time for the board to engage management in broad-ranging strategic discussions. Other boards reveal a desire to become more involved through, for instance, periodic board strategy days, off-site meetings with line executives and ongoing training.

While the concerns that surface through evaluations often focus on board procedures, they sometimes go to the basic relationship between the board and management, which can vary depending on the size and development stage of the company, the international makeup of the board and the current state of the business, Rollwagen says. In fact, the relationship between the board and the CEO is so central to their performance that the CEO evaluation should be conducted at the same time as the board evaluation, he says.

Board evaluations also can lead to tough discussions about the composition of the board itself and whether, as a whole, its experience and skill-sets are appropriate. Board evaluations may identify a need for additional — or replacement — directors to provide expertise in specific areas.

Whatever the results, the key to a successful board evaluation — one that promotes positive change on the board — is a full discussion of issues that are raised and a commitment to address them.

Going it alone or with help

Whether these issues are best surfaced by an internally driven evaluation or with the aid of an external consultant depends on the specific needs of the board. Some directors believe that an outside consultant's independence ensures that the process is more transparent and that issues are aired more freely. In addition, when there are problems on a board, the anonymity provided by working with an outsider not only encourages directors to speak more freely, but also ensures that comments by individual directors are shared with the whole board and don't get lost in the process.

We believe that there are additional benefits to working with an outside consultant that incorporates interviews

with individual directors into the evaluation process. While these one-on-one discussions can span the breadth of board responsibilities and operations, they are structured to draw out the particular concerns of individual directors. Flexible, broad in scope and undertaken by senior consultants with significant board-level search experience, our interview process helps to raise real issues that impede board effectiveness, which then can be addressed. The findings are compiled and shared, and used to facilitate board discussion.

One of our clients, the FTSE 150 director, has participated in board evaluations with several international companies, both with and without the assistance of an external consultant. While a well-written questionnaire can elicit frank comments from directors, he has found that internally managed evaluations often lack independence and sometimes are constrained by a desire to avoid ruffling feathers. Strong views, he notes, have a tendency to disappear from the final consolidated report that is shared with the full board. By contrast, external facilitators have helped boards to air difficult issues, enabling them to discuss the concerns fully and come to a consensus on how to address them.

“Working with an external consultant has huge benefits in terms of providing total anonymity and ensuring that there is no editing of issues raised by directors,” he says. “Underlying issues that wouldn’t come up in a written questionnaire rise to the surface only in an interactive process.”

Rollwagen believes that boards generally are up to the task of conducting their own evaluation. He typically begins the process with a well-planned written questionnaire, essentially a comprehensive checklist of the board’s responsibilities designed to stimulate thought on areas of improvement and solicit ideas and comments from directors. Essential to a successful evaluation, he says, is having an independent chair or a lead director to champion the process and also to serve as an independent resource for both the board and management, where each can go with concerns.

Nevertheless, Rollwagen says there are instances when a board should consider looking outside for assistance. “There are two reasons to have a facilitator in the process, in my opinion. One is if the board is dysfunctional in some

way — if directors aren't comfortable with each other for some reason, or the board is new, or hasn't established itself as a unit and so it could use some help in doing that. The other reason is if the board evaluation itself is a new process and the board needs help getting started," he says.

Whether going it alone or working with an external facilitator, the board must commit to addressing issues that are raised through the evaluation to achieve the benefits. At PartnerRe, the board uses the results of its evaluation to set board goals for the coming year, Rollwagen says, adding, "There's no point doing the evaluation if you are not going to improve."

Conclusion

New governance regulations and shareholder demands are pushing boards to perform at higher levels and accept more accountability and responsibility than in the past. Board evaluations are seen as an important tool for boards to assess whether they are operating efficiently and effectively — as a high-performance board.

Many companies will — and many more will be tempted to — meet these new standards in the most expedient manner. But boards that approach evaluations in this and other compliance-oriented ways likely are to be unsatisfied by the process and will lose the opportunity to gain valuable shared insight into the operation of the board and ways to improve its composition, processes and relationships.

Companies that will benefit the most from the practice will go beyond simply collecting director feedback. They will draw out the concerns of individual directors through one-on-one interviews, promote active, candid conversations about ways to improve the operation of the board and commit to addressing the issues raised through the process.

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Attracting the new breed of nonprofit directors

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The corporate governance spotlight that has shone brightly on public companies now is beginning to illuminate nonprofit boards. In the wake of external pressures to adopt the reforms outlined in the Sarbanes-Oxley Act, many nonprofit organizations are taking a much more disciplined approach to building and running their boards. Adding to the external pressures is the recent legal action brought forth by attorney generals in New York, Missouri and Illinois regarding nonprofit executive compensation, heightening the need for nonprofit boards to continually make the right strategic decisions.

The degree to which nonprofit boards are adopting best practices appears, however, to be somewhat dependent on the mission and size of the organization. Boards that historically have possessed a substantial amount of professional expertise, such as larger healthcare systems and academic institutions, may have less to alter when reviewing their corporate governance practices. “I think corporations could learn a lot from the more progressive nonprofit boards,” explains Bill Kreykes, former CEO of several major nonprofit hospital systems and currently the chairman of Trinity Health, a \$5-billion nonprofit organization that runs nearly 50 hospitals and more than 360 outpatient facilities. “For years, Trinity has been conducting thorough board evaluations. We are constantly evaluating the board’s role, the effectiveness of committee charters and individual performance. This process has greatly strengthened the board and the relationship between the board and the CEO.”

While historically nonprofits have been very effective in developing a diverse slate of directors that reflect their

constituencies, community and mission of the organization, a number of these boards may need to take a harder look at their board composition to support stronger corporate governance practices. Today, we are witnessing more nonprofit boards, like Trinity, embracing the same governance practices as public companies — with many evaluating current and potential directors to make certain the necessary business skills are at the table. In fact, we have noticed a surge in the number of nonprofit organizations turning to executive search firms to help improve the professionalism — both in composition and in best practices — of their boards.

Today's nonprofit director

Unlike corporate directors, nonprofit directors must have a particular passion for the organization's mission. But, increasingly, nonprofit directors must bring the skills and experiences required of a corporate director. How the best practices compare board by board, however, is dependent almost entirely on the board's sector and mission. However, there are certain attributes and best practices that are ideal for all nonprofit directors to possess.

Foremost, nonprofit boards require directors who are personally compelled by an organization's mission. "Nonprofit directors join because of their initial interest and commitment to the mission," says Dr. Judith Rodin, president of The University of Pennsylvania and who has served on the boards for the Brookings Institution, Catalyst, Philadelphia Chamber of Commerce, Innovation Philadelphia, Aetna, AMR Corporation, Electronic Data Systems and Comcast. "This passion is critical, especially because directors need to act as ambassadors for the organization, which requires both a financial and time commitment."

Along with a passionate commitment to the organization, today's nonprofit directors need to possess a strong set of business skills, with a particular focus on finance as a direct result of Sarbanes-Oxley. The larger the board, hopefully, the more likely they will have the necessary expertise in audit, budgeting, finance, governance and diversity.

"The impact of Sarbanes-Oxley has been very positive for Trinity. The role of the CEO and the chair at Trinity has

always been separated, but today we have a renewed discipline surrounding the audit committee,” says Kreykes.

Elizabeth McCormack, who serves on many nonprofit boards, including the MacArthur Foundation, agrees. She says, “The need for qualified directors to sit on or chair the audit committee has never been higher. No matter the size or sector of the nonprofit board, this understanding and knowledge is crucial.”

In the end, the similarities between what’s needed in a nonprofit director versus a for-profit director are greater than the differences. “My corporate board experience taught me that nonprofit directors, just like corporate directors, can be supportive of the mission, while also asking the critical questions about strategy and finance and evaluating if the board is doing its job,” says Dr. Rodin.

Challenges facing boards

While there are many nonprofit boards that are adopting the best practices of the corporate world, there are many others that are just beginning to review their composition and operating structure. Based on our experience, there are a number of obstacles that nonprofit boards often encounter when trying to enhance their governance practices.

First, resistance to change is high. What may serve an individual’s interest may not be best for the organization in the long term. This is especially true in organizations where nonprofit directors see their contributions as personal investments and they want to know their thoughts are being heard. If they perceive their voice is being taken away or diminished, they may be less likely to adopt the new practices.

The size of nonprofit boards also can pose a challenge to implementing change. Many nonprofit boards are quite large, with up to 50 to 60 members. In order to have a board that is run effectively — and to attract and retain key directors who can make meaningful contributions — organizations may need to reduce the number of directors.

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This often is a sensitive issue, as organizations do not want to offend powerful donors and others who have provided support for the institution. In many cases, if the number of board members cannot be reduced, boards may need to reexamine the committee structure to ensure the majority of work is being handled effectively and efficiently. To better manage this issue, some nonprofit boards will meet only three or four times a year as a full board; whereas the executive committee meets five to seven times a year, working through many of the strategic decisions.

The final obstacle to embracing best practices in corporate governance is updating new skills when the board doesn't change frequently. Just as with corporate boards, new skills are needed regularly for nonprofit boards, which require new directors to be added and others to be let go without making it disruptive to the organization. Some nonprofits manage turnover through strict term limits. Term limits not only allow more people to serve, but they also give boards the opportunity to review the types of skills and experiences that would best serve the board.

Managing transformation in board composition

In addition to overcoming the inherent challenges associated with improving governance in a nonprofit environment, the transformation of a nonprofit board also requires the support of the CEO and the chairman. Depending on the level of the board's sophistication, there are a number of steps boards can begin taking.

- > **RETOOL THE BOARD:** An often difficult and painful process, which requires a critical assessment of both board composition and process.
- > **DEVISE A SPLIT:** Create a management board (one that handles the policy/oversight/hiring/firing of CEO) and a fundraising/support board (e.g. "friends of the organization").
- > **OUTSIDE EXPERTISE:** Bring experts in on a short-term basis to work on specific committees. This is an interesting transitional solution when necessary skills are absent from the board; it's also a good way to educate others sitting on the board. However, this is not a long-term

solution and it most often occurs when compensation expertise is required.

- > **STAFF SUPPORT:** Put staff and resources behind major board initiatives. Healthcare organizations and professional societies that operate more like a corporate board are well-known for utilizing these resources.
- > **INTERNAL DEVELOPMENT:** Implement board orientation and education for new directors. “Penn has a significant board orientation program. It is not good business to just parachute new directors into the organization — not only is it a negative experience for the new director, but it disturbs the flow of the meeting. We also assign mentors for new directors and hold board retreats every few years. We have adopted many of these programs as best practices from the for-profit sector,” says Dr. Rodin.

Attracting the right director

Given the evolving role of nonprofit boards, identifying and attracting the right director is crucial. When recruiting new directors, be cognizant of the following factors:

- > **TIME:** Nonprofit boards are notorious for frequent and lengthy meetings. To attract business-minded directors, boards need to reevaluate both issues to make sure they are in line with director expectations while not diminishing the required oversight.
- > **PASSION:** Directors have to be attracted to the mission and believe in it. They join because they are drawn to the mission, so it’s critical that the meetings are useful and mission-relevant.
- > **PRESTIGE:** Directors want to be part of a prestigious nonprofit organization; a board’s brand is very important. However, serving on the board of a nonprofit cannot be viewed and/or sold as a hobby; there needs to be a high level of commitment.
- > **THE ROLE OF COMPENSATION:** While not critical, as most “traditional” nonprofits do not remunerate trustees/directors, this may become more important in the future.

Given the increase in responsibility and time requirements, both traditional and more disciplined nonprofits realize that director compensation may come into play.

- > **CEO:** Believing in the CEO of the organization, in many cases, may be as important as the organization's compelling mission.

Conclusion

The number of nonprofit boards that are starting to reexamine their board practices and composition continues to grow. Today's nonprofit boards — from large universities to small human service or arts organizations — are embracing governance best practices and want to ensure that each director brings the necessary professional and business skills to the boardroom.

But as McCormack points out, “the increased scrutiny on nonprofit boards may cause some members to mistake their role. Rather than making sure that the CEO is managing, the board may try to manage the organization. This would be a big mistake.”

“The best way to avoid this situation is to be proactive — ensure that the right people are selected for the board from the very beginning,” concludes Kreykes. “We have taken this approach at Trinity and, as a result, our directors come to the meetings with a focus on the broad strategic challenges and issues facing the organization.”

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