Board and director evaluations circa 2014

Although the concept of board evaluations has become widely accepted, much can be done to improve the process.

By Kristina Veaco and Cherie Sorokin

The corporate governance pendulum continued to swing toward greater board and individual director scrutiny in 2014, in large part based on investor interest. Investors have for some time focused on board practices, but more recently the intensity of their focus has centered on whether boards have the right members to oversee the organization, director tenure, and whether boards are looking closely at their own functioning.

In 2014, the Council of Institutional Investors (CII) called on public companies to include disclosure of the board evaluation process in proxy statements, essentially taking a practice that has been seen as private into the public arena. According to CII, "Disclosures about how the board evaluates itself, identifies areas for improvement and addresses them provide a window into how robust the board's process is for introducing change" and such disclosure is "an indication that a board is willing to think critically about its own performance on a regular basis and tackle any weaknesses." Per CII, "the board evaluation — and disclosure of the evaluation process — can be a catalyst for 'refreshing the board.' " CII added that its members "value specific details that explain who does the evaluating of whom, how often each evaluation is conducted, who reviews the results and how the board decides to address the results."

In early 2015, State Street Global Advisors issued its director tenure policy containing a formula reflecting the concern that long-tenured directors on boards may reflect "a lack of refreshment of skills and perspectives on the board." The ideal composition in their view would be a third new-tenured, a third mid-tenured, and a third long-tenured directors.

Concerns over board structure

There are many reasons for the constant pressure on director and board scrutiny, not the least of which are perceived continued shortfalls in corporate performance, oversized executive pay, and investor concerns (some might even say "second guessing") that boards are not always structured for the type of oversight required to achieve high-level performance over the long

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term in today's competitive environment. The calls for shorter tenures and board refreshment reflect those concerns. But term and age limits and other "objective" board refreshment practices are fairly blunt instruments for addressing performance shortfalls or for positioning the board for long-term effectiveness. In our experience, having a thoughtful process for evaluating the overall effectiveness of the board, including a process for evaluating the effectiveness of individual directors, is far more likely to lead to increased long-term board effectiveness. The key is to make sure these evaluation processes are thoughtful, comprehensive and viewed as critically important by boards.

Although initially hesitant, by the late 1990s many public company boards began to incorporate internally conducted self-evaluations of the board, and sometimes its committees, as a regular governance practice, perhaps largely in response to the adoption by CalPERS in 1997 of its seminal set of core principles and governance guidelines. The CalPERS stated position was that "no board can truly perform its overriding functions of establishing a company's strategic direction and then monitoring management's success without a system of evaluating itself" and it called for the establishment of performance criteria for boards as well as development of skill sets and "individual behavioral expectations for directors."

By 2005, the National Association of Corporate Directors in its *Blue Ribbon Commission Report on Board Evaluations* noted that the concept of board evaluations was "widely accepted." Individual director evaluations and peer reviews, however, were thought by many companies to be unnecessary at one end of the spectrum and "too disruptive" to board collegiality at the other, and many boards are still hesitant to embrace them.

Too often a check-the-box exercise

Surveys now show that directors themselves believe individual director evaluations, including peer evaluations, would improve the evaluation process, which they report is often a check-the-box exercise, not yielding significant results or changes.

The fact that many companies still rely on internally conducted board self-evaluations, often using written questionnaires that may quite literally call for check-the-box responses, contributes to a lack of effectiveness. The evaluation process, however, is evolving, with many companies moving beyond internal self-evaluations to engage independent third parties to conduct evaluations. Directors may be more likely to "open up" about issues to an independent governance consultant, who is usually in a better position than someone in-house to "speak truth to power," thus increasing the possibility that the entire evaluation process will be more candid and direct.

We believe there is an additional reason board evaluations are not yet as effective as they could be. We have seen that while many organizations have some form of board evaluations, few boards truly embrace the idea that the board evaluation (indeed all governance-related reviews) should enable the board to strategically examine the connection between the board's own processes and its own directors' performance and the company's performance over the long term. While most boards regularly take the time to look at the organization's strategy, and regularly re-examine assumptions about the business operations of the company, not enough boards yet devote an appropriate amount of time and attention to the operations of the board and the performance of its individual members. As a result, many board evaluations unfortunately are simply not as effective as they might be.

Improving the process

In our opinion, the following are important keys to improving the board evaluation process:

1. Board evaluations are most helpful when directors look on the evaluation process as a comprehensive strategic review of board operations — similar to looking at business operations — not just a series of individual practices and comparisons to what others do.

2. Individual director evaluations are critical. They offer board members the opportunity to consider their own effectiveness, and peer reviews offer the opportunity for constructive comments on the performance of directors. They engender a culture that directors themselves must perform and are not "entitled" to a board seat "for life," regardless of their external stature.

3. Oral interviews either alone or in conjunction with written questionnaires are imperative. Use of only written questionnaires increases the risk of check-the-box answers and decreases the likelihood of candor.

4. In the right circumstances, internally conducted evaluations can be helpful, but external third-party evaluators often have a better chance in eliciting candor from directors, and also of being able to relay tough messages back to the board and individual directors.

5. Regardless of the process, noticeable follow-up of issues that surface in the evaluation is essential for any meaningful progress to be made.

We firmly believe that making board evaluations more effective not only has the potential to improve board performance, but also to prevent piecemeal adoption of mandates or practices that are less likely to address whatever actual issues may be impeding board effectiveness.

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