Boardroom INSIDER

April 2018

The online newsletter for better boards and better directors — *Ralph Ward, Publisher/Editor*

DID FACEBOOK'S GOVERNANCE MAKE PROBLEMS INEVITABLE?

The role of a board of directors remains very similar no matter the company or organization it serves. The board's ambit in a large, public company is the most examined, but in closely held, venture, family, ESOP or even private companies it still takes on some universal duties. The board always serves as a fiduciary for the owners, both majority and minority. It monitors company controls, finances and legal safeguards, because a corporate charter is granted by government in exchange for meeting these standards. And the board is expected to protect the long-term value of the enterprise itself.

Now where does this Business School 101-level stuff fit in with the situation we've seen unfolding at Facebook? The company faces a storm of scandal for happily sharing private data on users with political firm Cambridge Analytica. This was preceded by reports that Russian and other foreign interests have regularly used Facebook as a conduit for fake political news to tilt elections, overall corporate efforts to harvest personal data, cyberbullying, "hate speech," tilting its political news, etc. Facebook finds itself trying to stave off government regulation by clumsily regulating itself. The above headaches brought a real-world market hit, with Facebook stock dropping $80 billion in late March.

Which brings me back to the role of corporate boards. Facebook is a textbook example of how hugely successful young tech firms can get the essentials of corporate governance very right *and* very wrong at the same time. The company's board could not be more impressive. COO Sheryl Sandberg, Marc Andreesen, Ken Chenault, Reed Hasting and Peter Theil are just a few of the names. No doubt Facebook's boardsmanship when it comes to meetings, committees, independence and information are first rate.

But Facebook has taken hits from activists for its basic governance structure. Facebook's dual-class stock setup puts power in the hands of founder Mark Zuckerberg to a degree that's outsized even for dot-coms. Zuckerberg is also Facebook's board chair and CEO (though Gates Foundation CEO Susan Desmond-Hellmann serves as lead director).

The unique history of corporate boards means that they gather very savvy people together and make them collectively dumb. Most often I see this happen through board meetings and administrative tools, but board leadership is a real factor as well. If someone has solid veto power through his stock structure, as well as both the CEO and chair position, the company becomes a reflection of both his strengths and weaknesses. And at the board level, there will be little in place to check those weaknesses.

-- ***RDW***

WRITING YOUR BOARD DIVERSITY POLICY

With corporate board diversity becoming a red-hot topic of late, boards, especially at public companies, find themselves facing lots of questions over pale, stale, male membership (questions for which most have few good answers). Since ignoring the matter or saying a few platitudes seem to have brought little progress, activists and women's business groups increasingly want to hear what corporations plan to do on diversity.

This means preparing and publishing a board diversity policy. But what should a diversity policy seek to achieve? What should it say -- and what *shouldn't* it say?:

- Board diversity policies typically start with a statement of company beliefs and rationale when it comes to a diverse board. An overview of the policies online finds that most are at pains to tie diversity to overall board quality and improved company results. At ***Intel***, the statement stresses "Our board is committed to actively seeking women and minority director candidates," and review of the policy's effectiveness is part of the Intel board's nominating committee mandate. The ***Thirty Percent Coalition***, a major women's advocacy group whose name summarizes their board representation goal, offers a policy template that spells out the business case for diversity in detail, including comments of support from business leaders and major funds.
- PR about the value of women on boards only goes so far, and needs to be followed up with real targets. However, there are different ways to state these. The Canadian law firm Osler, working with Canada's Institute of Corporate Directors, has crafted a ***template*** board diversity policy that provides several options. You may set a firm percentage goal for women directors by a certain date. You may set a diversity percentage that's open ended. Or, the board may specifically disavow setting a hard target. The latter seems the most popular approach as of now, but "if things don't get better, look for more pressure for hard numbers," says Victor Arias, a managing director at RSR Partners search consultants.
- Discussing tools and procedures the board will use to improve diversity forces you to develop a methodology, and also shows you're serious about results. Charlotte Laurent-Ottomane, executive director of the Thirty Percent Coalition, urges boards to include a "Rooney Rule" in its recruiting policy, building it into the nominating committee's bylaws. This requires the board to include women, minorities, and other target groups in all board searches. Statements that the board will work with diversity search firms, or women's board groups (such as Thirty Percent) to advise on searches also puts meat on the policy.
- An effective board diversity policy should build in controls and transparency to prove its value. Mandate annual disclosures on the gender and racial makeup of the board. This is also a good way to bake in other board make up practices, such as developing and disclosing a skills matrix of current board talent and board needs. "Put in a commitment to review this on an annual basis," counsels Laurent-Ottomane. A board diversity policy works best as part of an overall talent assessment and refreshment plan.

7 MEASURES TO SPOT "OVERBOARDING"

Director overstretch is a governance concern that waxes and wanes, but lately has come back as an issue for board and governance advisors. In late 2017, Institutional Shareholder Services nudged its measure of overboarding down to 5 board seats from 6, and big funds like BlackRock and State Street are raising the matter with their huge portfolios of companies.

Hard data on busy directors backs these complaints. A recent ***study*** from the Florida State Board of Administration finds a definite inverse relationship between the number of seats a director holds and company total shareholder return. "Corporate boards with above average levels of directorship exhibited lower average 5-year TSR performance of approximately 140 basis points (1.4%)" the SBA study concludes.

But here's the problem -- director "overboarding" is measured with a very basic yardstick. We look at how many other "boards" a director serves, as if that was a standard unit. To gain a true measure of whether a board member is in the green, yellow or red zone on overboarding, we need to crunch together a number of other factors that make a real difference. To gauge your own "board stretch score," try weighing such factors as:

- Basic number of boards on which a director serves. This is the base measure, but dig in further for the factors below.
- What type of organizations are involved? The gold standard here is the board of a publicly-traded company, but even these should be ranked by revenues, number of employees, and global footprint. All of these factor into how complex the director's role is, and how much time and effort are demanded.
- Add time for highly regulated industries, financials, and utilities.
- Private company board seats generally bring a lower overstretch score, but not always. Venture-owned companies may require a lot of director time and networking. Family-owned businesses as a rule demand less governance, but some of the world's biggest firms are privately held, and will require complex oversight.
- A director's role on the board is given too little consideration in overboarding measures. Obviously a board chair or lead director slot ties up more effort, as will a committee chairmanship. Individual committee functions

matter too -- audit committee membership is much more of a time and effort-sink than, say, a social responsibility committee.

- Even with these factors, a board seat's time score will be dynamic. A company turnaround, leadership change, M&A activity, restructuring, spinoffs or downsizing will push board activity up or down. So will sudden surprises, such as litigation, proxy activity, or a crisis (for that matter, board time required in the run-up to the annual meeting will differ from that in, say, summer vacation season).
- Nonprofits, charities, trusts, civic groups, and similar board commitments are often not counted in the proxy advisor tallies of board seats, but definitely tie up time and effort. A major civic organization battling a funding crisis or local scandal can devour as much board time as a Fortune 500 company.

These are a few of the complex, fast-moving factors that go into handicapping whether a director is truly overboarded or not. If this suggests that one director serving 4 boards may be stretched dangerously thin, while another with 4 board seats might have time to kill, you're correct.

Editor's Note: Here's a challenge to our readers in the consulting and advisory community -- this is the sort of "big data" project that requires some serious, ongoing number crunching, but could be truly valuable in improving governance. A formula to weigh all these items in calculating an individual's "overboarding" score is needed.

6 TIPS FOR UPDATING YOUR BOARD BYLAWS

Admit it -- could there be anything sexier than a discussion of board bylaws? OK, maybe browsing your bylaws is 700th on your top 10 list of board agenda items, but scheduling a periodic review, assessment and update of board bylaws truly is an important protection that belongs on any board calendar every year or two.

Think of the bylaws as a contract your board signed sometime in the past, but which now can contain some dangerous surprises. The company may have simply outgrown some provisions. Legal changes could make yesterday's best practice today's liability nightmare. You may even find your board has been doing something that directly contradicts your original bylaw mandates.

Here are bylaw bugs to look for *now*… before they explode:

- Startups or newly-public companies often "begin with basic vanilla bylaws that don't reflect the later nature and size of the company," says Jeff Cassin, of counsel with the Scarinci Hollenbeck law firm in New Jersey. A quick, simple bylaws statement may have worked to launch the company, but likely leaves out specifics on share classes, board makeup and elections, and the powers of investors that can now leave you vulnerable.
- In a time of activist shareholders (especially those targeting smaller companies), one hot issue is how to handle those who try to "penetrate the board," notes Barry Genkin, a corporate practice partner with Blank, Rome. Seeking to nominate activist directors has become a popular proxy tool, so "one area of concern is how easy or hard your bylaws make it to do this." Clauses on nominations for the board, who can propose them, and the standards they must meet often don't reflect current tactics and rules used to breach the boardroom. Ask legal counsel to review your current bylaws for vulnerabilities.
- The above bylaw tune-up area is crucial enough to cover 2 bullet points. Major U.S. proxy advisory firms Glass Lewis and ISS have their own standards of fairness for board nomination rules, seeking balance between an open boardroom door policy and tight restrictions. Consult these, and assure that your process "requires a person to go through due diligence so shareholders have the opportunity and ability to evaluate candidates," Genkin counsels.
- Review board powers and mandates. Who has the authority to call a special meeting of the board, or of shareholders? What are director terms, and who has power to oust a board member, and with what requirements? What constitutes a director conflict of interest? Case law and activist trends are constantly shifting these currents, so, again, seek sound legal input.
- Director indemnification and insurance coverage traditionally wasn't an issue in board bylaws, but Cassin suggests that the scope and scale of damages a director can face today should prompt a rethink. "These provisions are worth addressing in the bylaws now. Assuring that liability and indemnification are backed up increases the director comfort level."
- Finally, make sure that the nuts-and-bolts of your board bylaws keep up with trends. Most states now allow board business through telephonic and online meetings, and your bylaws need to address the rules on this. Look particularly at how quorums and vote tallies are confirmed, and electronic recordkeeping. Also, an easily overlooked shift is advance notice provisions for board and shareholder meetings. "In an electronic age, we tend to reduce the amount of lead time," notes Genkin. Weigh the notification times laid out in your current bylaws

compared to current best practices.

AUDIT COMMITTEE QUESTIONS FOR THE AUDITOR

Your board's audit committee is the one that handles the most technical and complex matters to come to the board, but also the ones most likely to uncover dangerous problems. Most of these arise through "required communications" between the committee and the outside auditor. Auditing standards spell out the format and content for these news bulletins, but how well does your committee dig into them?:

- For U.S. companies, the Public Company Accounting Oversight Board (PCAOB) a few years back set out Auditing Standard No. 16 for matters to be covered in communication with audit committees. Among the items the auditor must review are "Significant changes to planned audit strategy or significant risks initially identified," "Significant unusual transactions," "Auditor's evaluation of the quality of the company's financial reporting," "Difficult or contentious matters," "Corrected (and uncorrected) misstatements," and "Disagreements with management." As you can guess, any of these leave plenty of room for debate, politicking and discrete omissions that the committee must look for.
- Outliers such as material weaknesses and internal control issues will have been raised with management by the time the audit committee gets involved. The committee thus needs to ask not only about what was uncovered, but how it was addressed. "Once you filter through the feedback from the auditor, read the commentary to find out what happened behind the scenes," suggests Gail Kinsella, a partner in the New York audit firm Bonadio Group. For example, was a needed control nonexistent, poorly designed, or not operating effectively? Seek context.
- Audit committees too often "get hung up on specific matters," while missing the overall control environment's forest for the trees, notes Kinsella. An auditor's exception comment on an unapproved transaction may be easily clarified, for example. But was it a one-time error that happens in any system with fallible humans? Or are there underlying concerns that allow such failures? Focusing on the fact that on outlier was resolved may be a quick, simple approach, but be ready to dig deeper.
- Finally, the audit committee must satisfy itself that it has an honest, open take on communication and negotiations between the audit firm and management. "The auditor works with management, but ultimately works for the board," says Kinsella. Did the auditor have a relevant conversation with company staff that the committee doesn't know about? Were there issues originally raised in the audit that were settled between the auditor and management? If so, what were they, and were any of them contentious? What is the auditor's private take on the state of controls, the overall reporting structure, and various risks? "One on one feedback from the auditor is important to the committee."

BI ONLINE FINDS - 4/18

- The Conference Board has been one of the pre-eminent sources for business thinking for a century now, and that includes corporate governance. Check out their new dedicated ***board blog series*** with thoughts from some of the world's foremost governance thinkers (and check out my own ***contribution*** from January).
- PWC's Audit Committee Excellence series continues its … well, excellence with a valuable new article from Paula Loop. Check out her new ***paper*** on what makes for a good audit committee chairman.

Q&A: What Are Good (And Bad) Board Questions?

Q: *I've served on a number of boards over the past decade, including nonprofits, an ESOP, and recently my first public company board. The people I've served with have impressed me with their smarts and commitment, but I've noticed one important aspect of governance seems very random. Asking good questions has always seemed vital to an effective board, but the quality of board questioning is all over the map. Some directors ask rambling, vague, or "gotcha" questions. But then, sometimes a question that seems like an open-ended time waster turns into a valuable line of discussion. Can you suggest any rules for good board meeting questions?*

***A*:** Asking board questions is another fascinating, crucial aspect of governance that receives too little discussion. Googling "asking questions in board meetings" will bring lots of specifics on financials, risk, strategy, succession and so on… but little on what makes for a good approach to questions.

Part of the problem is that the boardroom climate seems designed to dampen good questioning. CEOs want to get on with their plans without board "pestering." Directors want to show off how clever they are, prove that they're awake, or (worst case) catch someone with a "gotcha" query. And open-ended, what-if questions too often set other directors moaning and looking at their watches.

Best bet is to move beyond question specifics and focus on intent, approach and the outcomes sought. If you were the questionee rather than the questioner, how would *you* prefer to be queried on this topic? Are you seeking a number or data point that someone obviously won't have off the top of their head? Good board questions are less likely to address a narrow metric than its implications. Technical reasons for a 2% increase in online shopping cart abandonment compared to the last quarter will be less revealing than what it suggests for strategy.

As this suggests, you'll find a good board question expands rather than narrows discussion. Canadian governance guru ***Tamara Paton*** observes that good board questions "serve as a platform for building relationships." These encourage, and even welcome, further dialogue. Asking if a balance sheet footnote refers to A or B is quickly answered, and then matters move on. Such quick queries are needed at times. But more effective board questions will lead to deeper follow-up questions, new insights, and fresh ideas. They inform and stimulate everyone else in the boardroom, and should set managers to considering new possibilities.

…NEWS FLASH…

Ralph Ward's new book, *The Board Seeker's Guide*, is coming this fall from ***Business Expert Press***! Stay tuned for details.

COMING IN BOARDROOM INSIDER --

- *MAKING STOCK OWNERSHIP GUIDELINES WORK*
- *WHAT'S COMING FOR PRIVATE COMPANY GOVERNANCE?*

Ralph Ward's upcoming Boardroom Masterclass and speaking engagements:

Great group for my March 27 speech on "What Your Board Doesn't Know" at the University of Texas, Dallas, ***Institute for Excellence in Governance***!

April, 2018 - ***BI*** Masterclass in Chicago for Marcus Evans.
June, 2018 - *BI* Masterclass for the Campden Family Business Conference, Madrid. ***PENDING 2018 DATES*** - For India, Pakistan.

Visit the ***speaker*** page on the *Boardroom INSIDER* site for links to keynote speech videos, and also my listing on the ***eSpeakers*** site.

RALPH WARD'S BOARDROOM INSIDER is published monthly for directors, CEOs, those who work with corporate and nonprofit boards (corporate secretaries, corporate counsel, support staff, and consultants), and those who are board prospects.
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