BOARD SELF-ASSESSMENT

Legal and Practical Considerations

By
Lorna A. Schnase, Esq.

August 4, 2004

Lorna Schnase has been practicing corporate and securities law for over 20 years.
Her practice emphasizes investment management matters,
primarily for registered mutual fund and investment adviser clients.

Lorna A. Schnase, Esq.
713-741-8821 (phone) • 713-741-8886 (fax) • lschnase@houston.rr.com (email)

TABLE OF CONTENTS

Heading	*Page*
THE CONTEXT	1
WHY SHOULD OUR BOARD CONDUCT A SELF-ASSESSMENT?	1
To meet legal requirements.	1
To meet other important expectations.	3
WHAT BENEFITS CAN WE EXPECT FROM A BOARD SELF-ASSESSMENT?	4
A Better, Stronger Board.	5
Greater Teamwork and Communication.	5
Focus and Legitimacy.	5
WHAT RISKS ARE INVOLVED IN BOARD SELF-ASSESSMENT?	5
A Litigation Roadmap.	5
Inappropriate Use.	7
Loss of Collegiality.	7
THE PREPARATIONS	8
HOW SHOULD WE PREPARE TO CONDUCT A BOARD SELF-ASSESSMENT?	8
WHAT METHOD SHOULD WE USE TO CONDUCT THE SELF-ASSESSMENT?	9
WHAT CRITERIA SHOULD WE USE TO MEASURE BOARD PERFORMANCE?	10
HOW LONG WILL A BOARD SELF-ASSESSMENT TAKE AND HOW MUCH WILL IT COST?	10
THE PROCESS	11
WHO SHOULD BE COVERED BY A BOARD SELF-ASSESSMENT?	11
WHAT AREAS SHOULD A SELF-ASSESSMENT COVER?	13
Structure, Process and Operations.	13
Responsibilities and Substantive Performance.	14
Individual Assessments.	15
WHAT TYPES OF INFORMATION SHOULD BE ELICITED?	16
THE FOLLOW-UP	17
WHAT SHOULD WE DO WITH THE RESULTS?	17
HOW OFTEN SHOULD WE CONDUCT A SELF-ASSESSMENT?	18

THE CONTEXT

Recent scandals have resulted in a wave of demands for corporate governance reforms, including those calling for boards of directors[1] to evaluate their own performance in an effort to strengthen and improve overall corporate management. As a result, boards are now conducting self-assessments in order to meet legal, investor, community or other expectations. This paper answers some of the more common questions about the key aspects of conducting board self-assessments. It also offers suggestions on how to design and implement an effective self-assessment process.

WHY SHOULD OUR BOARD CONDUCT A SELF-ASSESSMENT?

To meet legal requirements. Corporate scandals have led to a number of new legal requirements for U.S. companies, including several aimed at strengthening the performance of the board of directors. As a result, an increasing number of boards are now legally required to conduct self-evaluations in order to meet applicable corporate governance standards. For example, companies with equity securities listed on the New York Stock Exchange ("NYSE") are required to comply with Section 303A[2] of the NYSE Listed Company Manual. Section 303A imposes a host of corporate governance standards on listed companies, [3] among them the requirement to adopt corporate governance guidelines calling for a board self-evaluation at least annually to determine whether the board and its committees are functioning effectively.[4] Section 303A will impact *directly* the more than 3,000[5] U.S. and non-U.S. companies listed on the NYSE. Given the preeminence of the NYSE, however, Section 303A can be expected to impact *indirectly* many more companies, by setting the bar for corporate governance standards against which others will be measured.

Similarly, investment companies ("funds") registered under the Investment Company Act of 1940 ("1940 Act") also face new legal requirements in the wake of recent scandals. In particular, funds relying on certain exemptive rules adopted under the 1940 Act[6] are now required to meet fund governance standards imposed by

[1] The terms "board of directors," "board" and "directors" as used in this paper should be read more broadly to include trustees, governors and other groups of persons serving in a similar organizational capacity. Similarly, the term "self-assessment" should be read broadly to include an assessment, evaluation or review of the board's performance, whether conducted by the board itself or by a third-party for the board.

[2] See NYSE Listed Company Manual, Section 303A.00, Corporate Governance Standards, available on the NYSE's website at http://www.nyse.com/.

[3] See the NYSE Listed Company Manual for details on the applicability of its Corporate Governance Listing Standards to listed companies and the phase-in dates for compliance with the revised standards under Section 303A.

[4] NYSE Listed Company Manual, Section 303A.09, Corporate Governance Guidelines.

[5] NYSE Fact Book, available at http://www.nysedata.com/factbook/main.asp.

[6] The exemptive rules include Rule 10f-3 (permitting funds to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate); Rule 12b-1 (permitting use of fund assets to pay distribution expenses); Rule 15a-4(b)(2) (permitting fund boards to approve interim advisory contracts without shareholder approval where the adviser or a controlling person receives a benefit in connection with the assignment of the prior contract); Rule 17a-7 (permitting securities transactions between

regulation,[7] among them the requirement for the fund board to evaluate its own performance and the performance of its committees at least annually.[8] Although the fund governance standards under the 1940 Act are technically applicable only to the 4,600+ registered funds that rely on one of the triggering exemptive rules,[9] they can be expected to set an industry standard against which other funds will be measured as well.

Corporate scandals have not been the sole province of the U.S.[10] Corporate governance reforms are being considered or implemented for companies in dozens of other countries,[11] often calling for board self-assessment as part of those reforms. For example, the U.K. Combined Code on Corporate Governance[12] calls for boards to undertake a "formal and rigorous" annual evaluation of their own performance and that of their committees and individual directors.[13] Companies listed on the London Stock Exchange are required to explain in their annual report how and whether they have complied with the provisions of the Combined Code, and if not, why not.[14] Australia takes a similar approach, requiring companies listed on the Australian Stock Exchange to disclose whether they comply with best practice recommendations that include board self-assessment, and if not, why not.[15] Although companies are not expressly mandated to comply with the recommended best practices, a "comply-or-explain" approach will certainly exert pressure on companies to comply.

---

a fund and another client of the fund investment adviser); Rule 17a-8 (permitting mergers between certain affiliated funds); Rule 17d-1(d)(7) (permitting funds and their affiliates to purchase joint liability insurance policies); Rule 17e-1 (specifying conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange); Rule 17g-1(j) (permitting funds to maintain joint insured bonds); Rule 18f-3 (permitting funds to issue multiple classes of voting stock); Rule 23c-3 (permitting the operation of interval funds by enabling closed-end funds to repurchase their shares from investors); and proposed Rule 15a-5 (exemption from shareholder approval for certain subadvisory contracts).

[7] See amendments to Rule 0-1(a)(7) (17 CFR 270.0-1(a)(7)) under the 1940 Act, defining the term "fund governance standards," as adopted in Final Rule: Investment Company Governance, Release No. IC-26520 (July 27, 2004) (the "Adopting Release") and as incorporated into the exemptive rules listed in note 6, *supra*.

[8] Id.

[9] Adopting Release, *supra* note 7, at n. 89.

[10] Read about the scandals involving Italian food and dairy company Parmalat, Dutch retailer Ahold and French media conglomerate Vivendi at http://news.bbc.co.uk/1/hi/business/3340641.stm.

[11] See the website of the European Corporate Governance Institute for a listing of corporate governance codes from numerous other countries, at http://www.ecgi.org/codes/all_codes.htm.

[12] The U.K. Combined Code of Corporate Governance can be found on the website of the Financial Reporting Council at http://www.frc.org.uk/documents/pdf/combinedcodefinal.pdf.

[13] Id. at A.6.

[14] See Paragraph 12.43A of the UKLA Listing Rules available on the website of the U.K. Financial Services Authority at http://ww.fsa.gov.uk/ukla.

[15] See Listing Rule 4.10.3 of the Australian Stock Exchange and Principle 8 of the Principles of Good Corporate Governance and Best Practices Recommendations developed by the ASX Corporate Governance Council, which can be found on the ASX website at http://www.asx.com.au/about/pdf/ASXRecommendations.pdf.

These are but a few examples of legal standards that call for board self-assessment. Given the impact of recent corporate scandals and increasing public and political sensitivity to corporate governance issues, it would not be surprising to see self-assessments required in an increasing number of contexts in the future.

To meet other important expectations. In addition to meeting legal requirements, self-assessments can help a board to meet standards and expectations imposed by other sources, such as investors and the community at large. Surveys show that shareholders believe good corporate governance adds shareholder value and will therefore pay a premium for well-governed companies.[16] In light of this, it is not surprising that shareholder activists and institutional investors routinely request their portfolio companies to adopt specific corporate governance measures, including a formal board self-evaluation process,[17] as part of their efforts to improve long-term returns. This type of shareholder activism impacts not only the specific company targeted by activists but the corporate community at large, since once new governance measures are adopted at one company, others are often expected to follow suit.

Other prominent groups have also called for corporate governance reforms, including board self-assessments, such as The Business Roundtable,[18] The Conference Board,[19] the Investment Company Institute,[20] the Mutual Fund Directors Forum,[21] the National Association of Corporate Directors[22] and the American Bar Association.[23] Internationally, the Organisation for Economic Co-Operation and Development (OECD),[24] the World Bank,[25] the International Monetary Fund[26] and the International Corporate

---

[16] See, for example, the McKinsey Quarterly survey which showed that in 1999, over 80% of respondents were willing to pay a premium for the shares of well-governed companies in the U.S. and Western Europe. Coombes, Paul, and Watson, Mark, "Three Surveys on Corporate Governance," McKinsey Quarterly, No. 4 (2000), pp. 75-77.

[17] See, for example, CalPERS' U.S. Corporate Governance Principles, available on the CalPERS website at http://www.calpers-governance.org/principles/domestic/us/page05.asp; and the TIAA-CREF Policy Statement on Corporate Governance, available on its website at http://www.tiaa-cref.org/pubs/html/governance_policy/board_directors.html.

[18] See The Business Roundtable white paper, Principles of Corporate Governance (May 2002), available on its website at http://www.businessroundtable.org/pdf/704.pdf.

[19] See Executive Summary: Findings and Recommendations of The Conference Board Commission on Public Trust and Private Enterprise (January 9, 2003), available on the Conference Board's website at http://www.conference-board.org/pdf_free/SR-03-04-ES.pdf.

[20] See ICI Report of the Advisory Group on Best Practices of Mutual Fund Directors (June 24, 1999) ("ICI Report"), available at http://www.ici.org/statements/ppr/rpt_best_practices.pdf.

[21] See Report of the Mutual Fund Directors Forum, Best Practices and Practical Guidance for Mutual Fund Directors (July, 2004), available at http://66.216.74.187/PDFs/best_pra.pdf.

[22] See Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness.

[23] See the American Bar Association, Recommendations of the Task Force on Corporate Responsibility (March 31, 2003), available on the ABA's website at http://www.abanet.org/media/corpgov.pdf.

[24] See the OECD Principles of Corporate Governance (2004) at http://www.oecd.org/dataoecd/32/18/31557724.pdf.

[25] See the World Bank Template for Country Assessment of Corporate Governance (Rev. 3, June 2003) at

Governance Network[27] have weighed in on corporate governance, recommending their own governance standards or providing analysis on those implemented by others.

Of course, none of this has been lost on the media. A cottage industry already exists for the purpose of "ranking" or "rating" various corporate boards, with the purported aim of identifying the "best" and "worst" among them.[28] All of these ratings take into account corporate governance issues and often specifically identify board self-assessment as a positive factor weighing in favor of a board's rating.

Not only is the media watching corporate boards, it is watching politicians as well, who in turn are watching corporate boards. It is no shock that politicians of all stripes have jumped on the bandwagon in light of Enron and other scandals, proposing corporate governance reforms of one sort or another.[29] Arguably, this political momentum facilitated the unprecedented number of regulations that have been recently adopted aimed at governance reforms, including board self-assessments. In this rarefied environment in which basically everyone agrees that the system is "broke," boards will be under great pressure to implement all but the most unreasonable of the proposed reforms.

All of this adds to the general atmosphere that board self-assessments are now practically required, if not legally required, since organizations not living up to new expectations risk being branded "substandard" under prevailing norms even if technically not out of compliance.

WHAT BENEFITS CAN WE EXPECT FROM A BOARD SELF-ASSESSMENT?

A properly designed self-assessment offers a number of benefits that could help to improve board performance and thereby strengthen corporate management and the prospect that corporate goals will be achieved. Even prior to the adoption of legal mandates, many boards were already conducting self-assessments.[30] Undoubtedly, this

---

http://www.worldbank.org/ifa/CGTemplate_0603.doc.

[26] See IMF Reports on the Observance of Standards and Codes (ROSCs) at http://www.imf.org/external/np/rosc/rosc.asp?sort=date.

[27] See ICGN Statement on Global Corporate Governance Principles at http://www.icgn.org/organisation/documents/cgp/cgp_statement_cg_principles_jul1999.php.

[28] See, for example, Business Week magazine's "Good and Bad Boards by the Numbers" at http://www.businessweek.com/2000/00_04/b3665022.htm; and Chief Executive magazine's "5 Best and 5 Worst Boards of 1999" at http://www.chiefexecutive.net/bench/bwboards/99board.htm. See also The Corporate Library's board effectiveness ratings at http://www.thecorporatelibrary.com/Products-and-Services/board-effectiveness-ratings.html; and Forbes magazine's board scores at "Best and Worst Bosses: Spineless Boards" at http://www.forbes.com/free_forbes/2003/0512/106tab.html.

[29] For a listing of many of the politicians that have made proposals in the wake of recent scandals, see http://www.pbs.org/wgbh/pages/frontline/shows/regulation/watchdogs/reforms.html.

[30] According to one 2002 survey, 37% of boards already had a formal process for evaluating their performance. Ortiz, Kimberly, "Corporate Performance: The Governance Factor" ("Ortiz"), citing Korn/Ferry International, U.S. 29th Annual Board of Directors Study (2002). Another group found that roughly ½ the boards in their survey already conducted a formal board evaluation. Nadler, David, "How Self-Assessments Boost Corporate Boards," The Wall Street Journal On-line (11-25-03) ("Nadler"), citing preliminary results from a 2003 survey conducted by Mercer Delta Consulting and the Center for Effective Organizations at the

was in part because they recognized the organizational benefits that can result from effective self-assessment.[31]

A Better, Stronger Board. The goal of any board self-assessment should be self-improvement. Self-assessment lends itself to helping boards become better and stronger by more clearly defining their objectives, identifying their strengths and weaknesses and addressing areas needing change. A frank self-assessment can also improve the composition of the board by constantly evaluating the board's needs as compared to the skills and strengths offered by the individuals already on the board. Moreover, it is a prime opportunity to surface suggestions on how to streamline meetings, create more informative board materials and permit the directors to do their jobs more efficiently and effectively.

Greater Teamwork and Communication. The self-assessment process can also enhance the personal dynamic among directors, by facilitating communication on difficult issues and clarifying their roles, between the directors and executive management and among the directors themselves. The process can encourage a team approach to problems and inclusiveness of participation. At the same time, it can relieve potential problems of director isolation or the feeling that one director or small group of directors is bearing more than their share of the burden. Because self-assessments are typically conducted confidentially or at least outside the glare of a full board meeting, directors might be more forthcoming with criticisms or suggestions than they would be under other circumstances.

Focus and Legitimacy. Of course, directors are typically free to make suggestions or voice criticisms about the board's business at any time they feel is appropriate, so some may ask whether a formal self-assessment is just redundant or a waste of time. The answer to that is no. Formalizing the self-assessment process provides focus and offers a systematic, disciplined method for approaching issues, enhancing the effectiveness of the overall self-improvement effort. A formal self-assessment will set aside time to reflect on matters that may otherwise go unnoticed or unaddressed in the crush of daily business. Formalizing the process also provides context and legitimacy to the feedback gathered and enhances the chance that everyone will embrace reforms implemented as a result of the process. Indeed, the legitimacy of the board itself will be enhanced if it holds itself accountable for meeting standards identified in a systematic and formal self-evaluation, in the same way that the board should be holding senior management accountable through evaluation of the CEO.

WHAT RISKS ARE INVOLVED IN BOARD SELF-ASSESSMENT?

A Litigation Roadmap. The greatest legal risk involved in board self-assessment is that the process might surface information that could be used against the board or reflect negatively on the board or the organization as a whole. Questionnaires,

---

University of Southern California. Among the boards that have been actively engaged in self-assessment for years are those governing various non-profit organizations, educational institutions and local governmental groups, such as school boards and municipal boards.

[31] Directors asked to identify the governance reforms that would most positively impact board performance ranked board assessment third, after director independence and audit committee independence. Nadler, *supra*, note 30.

analyses, interviews, recommendations and other materials developed in the process are potentially subject to disclosure in discovery and could become a “roadmap” for litigation. Moreover, self-assessments may be subject to regulatory inspection and become the subject of administrative action for companies operating in regulated industries.

These concerns should not be taken lightly. One of the primary goals of the self-assessment process is to identify problems so that they can be corrected. The effectiveness of this process will be diminished if directors fear that their honest evaluation of problem areas heightens their exposure to legal liability. It would be counterproductive for directors to self-edit or engage in a purely cosmetic assessment out of fear that sharing candid self-criticism will become cannon fodder against them.

Unfortunately, the current state of the law does not offer a solution to this dilemma. At least one commentator has suggested that the law needs to be changed and that board self-assessments need to be legally protected, much like medical peer reviews,[32] in order to avoid boards taking a “don’t ask, don’t tell” approach out of fear of reprisal despite their best intentions to make things right.[33] For now, however, a peer review-type privilege does <u>not</u> exist to protect board self-assessments from discovery. Moreover, there is a question whether even that type of protection would or should shield a self-assessment from government regulators in an administrative action.[34]

One might ask whether the board could protect the results of a self-assessment by engaging a lawyer or law firm to conduct the process, thereby gaining protection from disclosure under the attorney-client privilege or work product doctrine.[35] However, the attorney-client privilege and work product protections are sometimes difficult to sustain even in the best of cases. The issue becomes even thornier for organizations subject to regulatory jurisdiction. Regulators might well take a position similar to that staked out by the SEC in a similar context, where it said that any reports required under its rules[36] are meant to be made available to it and thus are <u>not</u> subject to the attorney-client privilege,

---

[32] Medical peer reviews are commonly shielded from discovery in certain types of litigation by state laws that create a peer review evidentiary privilege and protect their confidentiality. See Scheutzow, Susan O., “State medical peer review: high cost but no benefit – is it time for a change?” <u>American Journal of Law and Medicine</u> (Spring 1999).

[33] Nadler, *supra*, note 30.

[34] A similar debate is underway with regard to corporate compliance audits, as to whether the results of the audit should be subject to discovery and inspection. See Schnase, Lorna, “Supervision of Sub-Advisers -- Part II, Practical Tips for Managing Risk,” *The Investment Lawyer* (January 2004), at n. 26. Compliance audits have been conducted for years by many companies to identify areas of potential weakness in compliance and are expected to become increasingly common as new regulations mandating compliance programs are adopted, for example, Rule 38a-1 adopted under the 1940 Act requiring funds to establish and implement compliance policies and procedures. In a similar way, the efficacy of compliance audits will be undercut if companies fear that the results will be used against them.

[35] Perhaps more realistically, one might ask whether the board could similarly shield not the entire self-assessment, but only those legal problems that are identified in the assessment by turning those specific matters over to an attorney for investigation and handling.

[36] Presumably now including board self-assessments, at least for registered funds.

the work product doctrine or other similar protections.[37] Moreover, boards that refuse to hand over materials to regulators or prosecutors on the basis of a privilege or similar protection run the risk of being viewed as "uncooperative"[38] and thus potentially suffering stiffer penalties in the event of enforcement.[39] This does not mean that boards should not assert those protections in appropriate cases, but rather that they should understand the potential consequences and risks of doing so.

At the same time that self-assessment raises the risk of surfacing discoverable issues, there is a countervailing legal benefit to consider as well. Self-assessment reduces the board's legal risk for failing to "watchdog" company matters adequately or failing to police its own actions. This suggests that directors should not avoid self-assessment altogether, or engage in an unhelpful cosmetic exercise, but rather engage in a constructive process with an accurate understanding and awareness of the potential risks and the potential uses or abuses of the results. This should include a clear understanding of any document retention policy in effect and applicable to the self-assessment process.[40]

Inappropriate Use. In addition to being disclosed as a result of discovery or regulatory action, there is also the risk that self-assessments will be leaked to the media or used in other inappropriate or harmful ways by those with access to them. In light of this, steps should be taken to ensure that the self-assessment process is handled internally with due regard to its confidentiality and sensitivity. Distribution of self-assessment materials should be restricted and participation in the process should be limited to those essential to its completion. This will help minimize -- although certainly not eliminate -- the risk that sensitive information will be leaked to the media or put to other inappropriate use.

Loss of Collegiality. There is another, less tangible risk of doing board self-assessments. Despite efforts to turn self-assessment into an opportunity to build teamwork, there is a risk that a formal evaluation will damage the collegiality and undermine rapport among directors since they are expected to provide a critical evaluation of their colleagues. This concern would be particularly acute if the self-assessment process included a peer evaluation of individual directors.

Although this is a legitimate concern, one study reports that, to the contrary, formal evaluations tend to increase the level of rapport and improve the quality of

---

[37] See Final Rule: Compliance Programs of Investment Companies and Investment Advisers, SEC Release Nos. IA-2204 and IC-26299 (December 17, 2003), at n. 94.

[38] See Cohen, Laurie P., "Prosecutors' Tough New Tactics Turn Firms Against Employees," *The Wall Street Journal*, June 4, 2004, p. 1, which discusses how companies often waive the attorney-client privilege in order to be viewed as cooperative with investigators or prosecutors.

[39] See for example Speech by SEC Staff: 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute by Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission in Chicago, Illinois (April 29, 2004) at http://www.sec.gov/news/speech/spch042904smc.htm#13, in which Mr. Cutler outlines the factors used by the SEC in calculating penalties, including the third core factor, which is the extent of the violator's cooperation.

[40] See Report of the NACD Blue Ribbon Commission on Board Evaluation at pp. 26-27, for a more complete discussion of legal liability exposure and document retention in the context of board evaluations.

communication among the directors.[41] Moreover, several steps could be taken to minimize this concern:

- focus the evaluation on the overall group;
- have individual directors review only themselves, at least in the first year, then phase in peer reviews in a subsequent year, once the group is more comfortable with the process;
- design the process to maintain the confidentiality of remarks, for example, by having questionnaires and interviews handled by a trusted board advisor or staff member and having assessment results compiled into summary form; and
- ensure that all criticisms are handled constructively.

Directors should be able to maintain their collegiality if the process is approached in the spirit of self-improvement through constructive criticism. Indeed, if problems with collegiality are detected, they should be raised in the self-assessment process since the effectiveness of the process itself should be one area of inquiry.

THE PREPARATIONS

HOW SHOULD WE PREPARE TO CONDUCT A BOARD SELF-ASSESSMENT?

The first step in preparing for a self-assessment is to identify who is going to spearhead the effort. Self-assessments typically fall within the purview of the Nominating Committee or the Corporate Governance Committee for boards that have those committees. Whether the board has those committees or not, a well-respected independent director should be tasked with leading the self-assessment and given access to the resources necessary to accomplish the effort. An outside consultant or other third party can be engaged to conduct or help with the self-assessment. However, even in that event, one director should be designated as the lead board member to interface with the consultant for purposes of the assessment.

The next step in preparing for a self-assessment is to identify the goals and standards the directors are expected to meet. Only with a clear understanding of what is expected of the board can an effective assessment be done of whether it is meeting those expectations. This preparation can serve to educate the directors as well. It might start by consulting various sources that help to define goals and standards, including:

- applicable statutes, regulations or other laws affecting board conduct;
- organizational bylaws;
- other board mandates, perhaps reflected in minutes;
- director position descriptions;
- board committee mandates, perhaps reflected in the bylaws, minutes or committee charters;
- corporate codes of conduct or codes of ethics;
- memoranda or other advice of counsel addressing board matters;[42]

[41] Korn/Ferry International, “Evaluating the Board of Directors” (1998) (“Korn/Ferry”), at p. 10.

[42] In the case of a mutual fund board, this might include the so-called “fiduciaries memo” or “Gartenberg memo” typically prepared by counsel to the independent directors and outlining board responsibilities under state and federal law.

- communications or correspondence with other sources relating to board matters, such as letters from shareholders, media reports, deficiency letters or similar communications from regulators, and so on.

It is important that the board agree on goals and standards to build a consensus about what criteria will be used to measure board performance. The agreed on goals and standards can then be used to inform the design of the self-assessment process and prepare any materials or tools used in that effort.

Other steps should also be taken to prepare the directors for a self-assessment. First, the directors should be given a clear explanation of the purpose of the self-assessment and an overview of the entire process, well before they are asked to fill out any questionnaires or otherwise participate in the effort. They should be advised about the steps being taken to preserve confidentiality of their comments and confidentiality of the results. They should be informed about the risks of self-assessment as well as be advised or reminded of any applicable document retention policy.

Second, directors should be encouraged to participate in all appropriate aspects of the process. Broad participation will serve the goal of enhancing inclusiveness and teamwork among board members and help to build a consensus about critical features of the self-assessment. It will also enhance "ownership" of the process and ultimately the legitimacy of its results.

WHAT METHOD SHOULD WE USE TO CONDUCT THE SELF-ASSESSMENT?

There is no "one size fits all" method that every board should use to conduct its self-assessment. One or more of a number of different methods might be used effectively, among them:

- questionnaires/surveys;
- one-on-one interviews (in person or by telephone);
- evaluation by an outside consultant or expert; or
- observations of directors, management and/or senior staff compiled into summaries.

Boards must decide which method or combination of methods is right for them, depending on factors such as the size of the board, the available budget, the personalities involved and the comfort level of individual directors.

One study reports that board self-assessment is usually conducted through a lead director or respected counselor who distributes a questionnaire to every director and then follows up with a confidential one-on-one interview in person or by phone.[43] While this may not be the right method for every organization, it offers the opportunity for a more objective measure (questionnaire) to be supplemented with frank talk (interview).

One issue boards will have to face is whether the assessment will seek input from sources outside the board altogether, for example, from members of senior

---

[43] Korn/Ferry, *supra*, note 41, at p. 12.

management who do not serve as directors but who interface with the board routinely. They may have valuable insights on board performance and could be included in the methodology even if not to the same degree or in the same way as the directors themselves. Boards might also consider seeking comment on their performance from large investors, industry analysts or other corporate constituents.[44] Although this could uncover helpful insights and reinforce the perception that the board understands its role, it would be prudent to approach making contact of this nature only with caution.[45]

WHAT CRITERIA SHOULD WE USE TO MEASURE BOARD PERFORMANCE?

In a broad sense, self-assessment should measure board performance against the goals and standards identified in the preparation process.[46] Performance relative to some of these goals and standards will be easier to measure than others. For example, if an audit committee charter calls for quarterly committee meetings, it will be easy to assess whether the committee is fulfilling that requirement. In contrast, it will be more difficult to assess a less objective issue, such as whether the audit committee is meeting frequently “enough” even if it is fulfilling the minimum requirement. Nonetheless, inquiry can be made along those lines, against the general backdrop of a director’s fiduciary obligation to act with due care. One can ask whether the committee has addressed all the agenda items appropriate for it to consider and whether those items are being addressed in a timely manner. Committee members can be asked whether they are overly rushed during meetings or whether they have enough time at meetings for due deliberation and discussion. Factors like these might weigh into an assessment of whether the committee is meeting frequently “enough.”

Outside measures may also be useful to assess the board’s performance, for example, information on how things are done on other boards, which can be gathered by direct research or by consulting publicly available surveys and media reports. Information might also be gathered on standards proposed or recommended by well-respected authorities or commentators, such as The Business Roundtable and others mentioned previously.[47] This type of comparative information could then be presented for consideration as part of the overall assessment.

HOW LONG WILL A BOARD SELF-ASSESSMENT TAKE AND HOW MUCH WILL IT COST?

It is impossible to predict the time and cost necessary for any particular board to conduct a self-assessment. Time and cost will be driven by factors such as what

---

[44] See Sullivan, Katherine McG., and Gregory, Holly J., “Creating a Board Self-Evaluation Methodology,” The Metropolitan Corporate Counsel (March 1996) (“Metropolitan”). See also Korn/Ferry, *supra*, note 41, at p. 12, which says that their research shows very few companies are actually gathering information from non-board members in order to evaluate their effectiveness.

[45] And, where applicable, with due regard for legal provisions governing disclosure of information to the public, such as SEC Regulation FD.

[46] See the discussion above under the heading “The Preparations; How Should We Prepare To Conduct A Board Self-Assessment?”

[47] See the discussion above under the heading “The Context; Why Should Our Board Conduct a Self-Assessment? To Meet Other Important Expectations.”

methods are used, whether an outside consultant is hired, and so on. However, several observations can be made. First, the board's initial self-assessment can be expected to take longer than subsequent efforts, since it will include hashing though the basic questions of process design and the initial preparation of the assessment materials. Assuming no major changes, the process can be expected to become more efficient in subsequent years and therefore less time-consuming and costly to complete. Precautions should be taken, however, to avoid the process becoming mechanical and thoughtless as time wears on.

Second, in order to be effective, the process need not be either costly or time-consuming. As with most efforts, the effectiveness of a self-assessment will be determined more by how much thought and focus is put into the effort than by how much time or money is spent getting it done. Well-crafted but simple questionnaires and telephone interviews could be as effective as an expensive "executive leadership" or "team building" exercise at a weekend retreat facilitated by a high-priced consultant. The key will be whether the directors are prepared, motivated and committed to using the tools provided to accomplish their self-assessment goals.

Finally, although one can measure and discuss how long it takes to complete director interviews or tabulate the results of a questionnaire, self-assessment would be better thought of as an on-going, continuous effort rather than as a discrete exercise accomplished in a matter of hours or days. One Korn/Ferry board evaluation model reflects this in a timeline that starts with performance goals set at the beginning of the fiscal year, and continues until the board has assessed itself against those goals at the end of the fiscal year.[48] Then, new goals are set for the upcoming fiscal year. Under that model, the self-assessment process could be thought of as taking an entire year to complete, or even as a continuous process without a beginning or end.

THE PROCESS

WHO SHOULD BE COVERED BY A BOARD SELF-ASSESSMENT?

It is axiomatic that a board assessment should cover the performance of the board as a whole. However, there are several nuances that should be addressed as well. First, boards should ask whether the assessment should cover and involve the participation of "inside" directors, meaning directors who also serve on the organization's management such as the CEO, or whether it should cover just include the "outside" or "independent" directors. In many cases, insiders can be expected to have unique insights into the inner workings of the board that might help in the overall effort to improve board performance. Moreover, insiders are part of the fabric that makes up the board and including them in the self-assessment process has intuitive appeal for the sake of completeness. Even though insiders might be reviewed separately in their capacity as senior executives, reviewing their performance as <u>directors</u> fits logically into the board evaluation process. Nonetheless, in some cases, divisiveness between the outside directors and management or individual personality conflicts may make it counterproductive or unwise to include inside directors in the board assessment process. The decision, therefore, of whether or how to include insiders would be best made on a case-by-case basis.

[48] See Korn/Ferry, *supra*, note 41, at p. 13.

In addition to evaluating the board as a whole, a board self-assessment should also evaluate the performance of the board's committees. Indeed, evaluations mandated by the NYSE for listed companies and by the SEC for registered funds are required to consider the performance of committees in addition to the board as a whole.[49] This makes practical sense, given that much of the important work of the board is often conducted at the committee level.

There is less agreement over whether a board self-assessment should cover individual directors.[50] A recent study showed that although 72% of directors believed that the performance of individual directors should be evaluated regularly, only 21% of boards were actually doing them.[51]

Certainly, individual director evaluations raise concerns that go beyond those associated with a whole board evaluation. The risk that peer reviews could undermine board collegiality has already been discussed.[52] Directors who are often accomplished and respected individuals could understandably be wary of or offended by the notion that they have to "prove" themselves as worthy board members. However, one study shows that directors themselves rate the effectiveness of their boards significantly more positively in cases when individual board members are evaluated than when they are not.[53] Moreover, all those directors who have been frustrated by underperforming individuals serving on their boards should welcome a constructive, proactive method for addressing that problem and perhaps even paving the way for their removal.

Boards could consider one or more of the following steps to ease concerns about individual director evaluations:

- as was previously suggested, starting the assessment of individual directors in the first year by having directors only review themselves, then phasing in peer reviews in a subsequent year, once the group is more comfortable with the process;
- using a simple pass/fail system, rather than a detailed scale or more complex system that might belie how well the directors actually know one another or overemphasize the importance of individual evaluations in the process as a whole;

---

[49] See Section 303A of the NYSE Listed Company Manual and SEC Rule 0-1(a)(7)(iv) under the 1940 Act. Registered funds are also required to consider the number of funds on whose boards each director serves.

[50] For example, of those governance standards previously discussed, the U.K. Combined Code and the Australian Stock Exchange best practice recommendations both call for individual directors to be evaluated, whereas NYSE Section 303A and SEC Rule 0-1(a)(7) make no mention of individual directors. The NACD Blue Ribbon Commission, The Business Roundtable, The Conference Board, the Mutual Fund Directors Forum and the ABA Task Force call for individual directors to be evaluated, whereas the ICI does not.

[51] Ortiz, *supra*, note 30, citing Korn/Ferry International, U.S. 29th Annual Board of Directors Study (2002). According to Ortiz, 59% of directors on those boards conducting individual director evaluations also said that the evaluations were ineffective.

[52] See the discussion above under the heading "The Context; What Risks Are Involved in Self-Assessment? Loss of Collegiality."

[53] Korn/Ferry, *supra*, note 41, at p. 14.

- using an objective, professional evaluator to assess individual directors, rather than a director-to-director peer review;
- assessing only individual directors if they hold key positions, such as committee chairs;
- circulating a summary of the results only to the director evaluated and to the Nominating Committee or whoever is charged with the responsibility for taking action with respect to underperforming directors.

Of course, ensuring that peer reviews are handled confidentially will also add to the overall feeling that the process is being conducted sensitively and constructively.

WHAT AREAS SHOULD A SELF-ASSESSMENT COVER?

Here again, there is no "one size fits all" solution. What areas a board assessment should cover depends on what type of organization it is, what industry it operates in, how large and complex it is, and a host of other factors that make it difficult to develop a single model suitable for all. However, most organizations will have a number of issues in common, which can be identified at least in general terms. These issues might be categorized in myriad different ways, but for the sake of discussion, they are placed here into two broad categories: (1) the board's structure, process and operations; and (2) the board's responsibilities and substantive performance.

The following lists are offered only for the purpose of illustrating the types of issues that might be relevant in each category of inquiry. These lists should not be considered complete and should never be used without appropriate tailoring for a particular organization's needs.

Structure, Process and Operations. The issues to be addressed here might include:

- whether the board is chaired by the right person;
- whether the board and its committees are the right size;
- whether the board has the right number and type of committees;
- whether the board's composition is right and includes the right mix of backgrounds, skills and experience;
- whether the length of tenure of the board's members is about right;
- whether the process for identifying and selecting new director candidates is appropriate;
- whether committees consist of the right directors;
- whether committees are chaired by the right directors;
- whether the board and its committees meet with the right frequency;
- whether the length of board and committee meetings is right;
- whether the location and accommodations for board meetings are adequate;
- whether the materials provided to the directors are useful, sufficient and properly focused;
- whether materials are received far enough in advance of the meeting to allow for a thorough preparation;
- whether the board as a whole is generally well prepared for meetings;
- whether the board is kept adequately informed of all material issues;

- whether director requests for information are reasonable in amount, time frame and otherwise to enable timely and complete responses;
- whether the board focuses on meaningful matters and whether meetings are productive;
- whether the agenda is established in an appropriate manner;
- whether the format for discussions is appropriate and conducive to reaching a timely and constructive conclusion;
- whether there is enough time devoted to discussing the issues directors consider important;
- whether directors participate actively, ask pertinent questions and contribute meaningfully to deliberations;
- whether the board handles its workload efficiently and effectively;
- whether the level of meeting attendance is appropriate;
- whether there is sufficient opportunity for the independent directors to meet separately from management;
- whether the board as a whole functions cohesively and effectively on the basis of mutual respect;
- whether the culture encourages frank and open discussion among directors and accommodates differences of opinion;
- whether the board has adequate access to management outside of formal board meetings;
- whether the board has sufficient access to counsel and other resources necessary to function effectively;
- whether the board's method for monitoring its own progress in meeting goals is adequate;
- whether the board adequately follows through on issues;
- whether the board's deliberations and decisions are adequately documented;
- whether the board adequately monitors and evaluates its own performance and corrects identified problems;
- whether the board self-assessment process is effective or should be changed in some fashion.

Responsibilities and Substantive Performance. The issues to be addressed here might include:

- whether the board has sufficiently defined, understands and adheres to its roles and responsibilities;
- whether the board sufficiently understands the organization's business, strategy and industry;
- whether the board is and acts sufficiently independent of management;
- whether the board is both sufficiently supportive and sufficiently challenging of management;
- whether the division of authority and allocation of responsibilities between the board and executive management are clear;
- whether the board's goals, expectations and concerns are openly and effectively communicated to management;
- whether board committees function as intended by the board;
- whether the directors are given adequate orientation and training;
- whether directors are given an adequate opportunity for continuing education and for expanding their relevant skills;

- whether the board is firmly committed to being held accountable;
- whether the board has a relationship of mutual trust and respect with senior management;
- whether senior management responds appropriately to board requests and needs;
- whether the board is appropriately involved in the process of developing the organization’s policies and strategic direction;
- whether the board understands and is in agreement with management’s business objectives and criteria for evaluating whether those objectives have been achieved;
- whether the board has access to sufficient performance, competitive and industry information to allow it to monitor the organization’s results and identify potential concerns;
- whether the board as a whole is kept adequately apprised of the work of board committees;
- whether the board sets director compensation in an appropriate manner and to create appropriate incentives for directors to perform;
- whether the board regularly reviews the performance of the CEO and/or other senior management;
- whether the board has designed a management compensation plan creating appropriate incentives to perform;
- whether the board has adequately considered management succession;
- whether the board has adequately considered the organization’s readiness for a crisis;
- whether the board is effective in ensuring ethical behavior and compliance throughout the organization, including adherence to codes of conduct;
- whether the board is effective in ensuring that risks and conflicts of interest faced by or within the organization have been identified and that policies and procedures have been developed to address them;
- whether the board appropriately considers and treats the interests of shareholders, employees, customers and other corporate constituencies.

Individual Assessments. Boards that undertake the assessment of individual directors might consider inquiring into these issues, among others:

- whether the director understands and stays within the defined role of a director;
- whether the director has special expertise that is important to the organization or the board;
- whether the director regularly attends board and committee meetings;
- whether the director constructively contributes to board and committee meetings;
- whether the director is well prepared for meetings;
- whether the director stays abreast of issues and trends affecting the organization;
- whether the director is available outside of meetings when necessary to address relevant matters;
- whether the director is willing to challenge management when necessary;
- whether the director fosters and facilitates teamwork on the board.

WHAT TYPES OF INFORMATION SHOULD BE ELICITED?

As already discussed, various methods could be used to conduct a self-assessment, from questionnaires to interviews to consultant reports and so on. No matter what method is selected, there are advantages to be gained by eliciting both quantitative and qualitative types of information.

Quantitative information is information that calls for a rating scale, check the box, "choose your answer" or other similar response that is quantitative in nature. Standardizing or categorizing responses in this way makes them more susceptible to tabulation by quantitative methods and allows for quick and definitive analysis of results. Depending on how the question or issue is worded, quantitative or "scaled" responses might include, for example:

- Strongly Agree, Agree, No Opinion,[54] Disagree, Strongly Disagree (or a 1 – 5 point scale correlating to these categories);
- A – F "grading";
- Very Good, Good, Average, Fair, Poor;
- Yes, No, Partially;
- Exceeding Expectations, Doing the Basics, Not Fulfilling Obligations;
- Pass/Fail or Adequate/Needs Improvement.

Some self-assessment tools ask respondents to identify trends as well, for example, "12-month trend better" or "12-month trend worse," which could be useful to assess whether previously identified problems are being adequately addressed or whether areas that are nonetheless still satisfactory may be slipping.[55]

In contrast to quantitative information, qualitative information provides the opportunity for free-form or prose responses. Free-form responses allow for a more in-depth and nuanced probe into issues and may even surface issues that are not covered by the quantitative inquiry at all.

Both quantitative and qualitative information could be gathered by any of the methods discussed for conducting a self-assessment. For instance, a questionnaire could have one section calling for "circle your response" answers and another section calling for written prose comments. Or, an interviewer could ask respondents to evaluate performance in various areas as "Adequate" or "Needs Improvement" and then ask them to expound on any areas identified as a concern. Boards should determine for themselves the best method for eliciting the desired information based on their specific circumstances, but they will have greater ability to interpret the results and surface important issues if the information elicited is both quantitative and qualitative in nature.

Aside from what types of information are elicited, various opinions exist over whether the information should be committed to writing and, if so, how much of it. The

[54] Or "Not Decided," "Not Sure" or "Neither Agree Nor Disagree."

[55] Some questionnaires also permit respondents to check boxes for "DK" (don't know) or "NA" (not applicable), although a better designed questionnaire should be able to avoid either of those responses altogether.

threat of potential discovery in litigation[56] has led some organizations to avoid committing any self-assessment materials to written or other tangible form.[57] However, this presents several issues and difficulties:

- It narrows the range of methods that can be used in the self-assessment process, effectively eliminating the use of written questionnaires and written reports, which are some of the most commonly used tools in board evaluation.
- It forces directors to have to rely on their memories in the event their self-assessment or follow-up is ever challenged. While faded memories might be helpful in some cases, they can also be harmful in cases where important facts that show the board properly discharged its duties have faded into obscurity.
- It is at odds with the recordkeeping obligations of some regulated organizations (such as registered funds) and with the attitude sometimes attributed to regulators (such as the SEC) that if something is not adequately documented in writing, it will be treated for regulatory purposes as if it doesn't exist.[58]

At a minimum, then, boards should decide whether the risks of creating written materials outweigh the benefits before deciding to avoid written materials altogether. Boards may find it more practical to utilize those written materials that are the most advantageous to achieving their self-assessment goals and avoid materials that may present unnecessary risk. In addition, as already mentioned, all participants involved in the process should be advised or reminded how the organization's document retention policy applies to materials created in the process.[59]

THE FOLLOW-UP

WHAT SHOULD WE DO WITH THE RESULTS?

Results from a self-assessment should be compiled and summarized into a digestible form and presented to the board as a whole.[60] Ideally, this should be done as part of a formal board meeting, with adequate time set aside for the board to discuss the

---

[56] See the discussion above under the heading "The Context; What Risks Are Involved in Self-Assessment? A Litigation Roadmap."

[57] Nadler, *supra*, note 30.

[58] See the recordkeeping Rules 31a-1 and 31a-2 applicable to funds under the 1940 Act. Note that in the Adopting Release for Rule 0-1(a)(7), the SEC said that although the rule does <u>not</u> require the board's self-assessment to be in writing, the SEC nevertheless expects the board minutes to reflect the substance of the matters discussed during the self-assessment. Adopting Release, *supra* note 7, in text surrounding n. 63.

[59] See the discussion above under the headings "The Context; What Risks Are Involved in Self-Assessment? A Litigation Roadmap" and "The Preparations; How Should We Prepare To Conduct A Board Self-Assessment?"

[60] As previously mentioned, boards may want to consider limiting the distribution or discussion of individual director assessments and should consider whether or what portion of the presentation to the board should be in written or oral form.

results. This is the board's principal opportunity to assess the current state of its performance and decide on a course of action for making any necessary improvements.

In the presentation, appropriate credit should be given where due for strengths identified by the assessment. At the same time, any weaknesses or problems that were uncovered should also be clearly identified because it is critical that the board treat them as "red flags" requiring due follow-up and resolution. Legally, failure to follow up on a problem or "red flag" can be as bad, if not worse, than failure to find it, particularly if the problem relates to legal compliance or internal controls, such as auditing or financial controls.[61] Whether or not the board might be culpable for a problem existing in the first place, failing to address the problem once identified could spawn allegations that the board is responsible for harms that occurred during the time the problem continued or got worse because the board failed to take corrective action. As a result, the follow-up to a self-assessment can be as important as the assessment itself. As with all issues addressed by the board, issues uncovered by a self-assessment should be discussed, prioritized, tasked and driven to a timely conclusion.

HOW OFTEN SHOULD WE CONDUCT A SELF-ASSESSMENT?

Board evaluations are usually conducted annually.[62] Board evaluations mandated by the NYSE for listed companies and by the SEC for registered funds are <u>required</u> to be conducted at least annually.[63] Annual evaluation is also called for by virtually all the other previously mentioned authorities and organizations that have set board self-assessment standards.[64] Although self-assessments are apparently done by some boards every other year,[65] the clear evolving standard is at least every year.

The self-assessment process itself should also be evaluated annually. Directors should be given the opportunity to comment on whether the process is effective and, if not, how it could be improved. This will permit refinements to the process from year to year and allow for the efficiency and effectiveness of the process to evolve over time.

* * *

---

[61] Failure to follow up on red flags is a recurring theme in enforcement actions by the SEC. See, for example, Western Asset Management Co. and Legg Mason Fund Adviser, Inc., Advisers Act Rel. No. 1980 (September 28, 2001); In the Matter of Back Bay Advisors, L.P., Release Nos. IA-2070 and IC-25787 (October 25, 2002); In the Matter of Kirkpatrick, Pettis, Smith, Polian Inc., Peter N. Lahti and Gregory D. Adams, No. 34-48748 (November 5, 2003); and Speech by SEC Staff: Remarks before NAVA's 2004 Regulatory Affairs Conference by Mary Ann Gadziala, Associate Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (June 15, 2004), at http://www.sec.gov/news/speech/spch061504mag.htm.

[62] Korn/Ferry, *supra*, note 41, at p. 12.

[63] See Section 303A of the NYSE Listed Company Manual and SEC Rule 0-1(a)(7)(iv) under the 1940 Act.

[64] See the governance standards of the authorities and organizations referenced above under the heading "The Context; Why Should Our Board Conduct a Self-Assessment? To Meet Other Important Expectations."

[65] See Korn/Ferry, *supra*, note 41, at p. 10. Certainly, boards could rationally conclude that not all facets of their activities need in-depth evaluation every year, but should also recognize that certain aspects may occasionally require even more frequent attention.

Following the suggestions in this paper will help boards to design and implement an effective self-assessment process. This will, in turn, allow them to meet legal, investor, community or other standards that now expect board assessments as part of a system of corporate governance aimed at strengthening and improving overall corporate management.