

THE CORPORATE BOARD

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Shaping The Nominating/ Governance Committee

The board's new "do it all" committee.

by H. Stephen Grace, Jr., Ph.D. and John E. Hauptert

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Shaping The Nominating/ Governance Committee

by H. Stephen Grace, Jr., Ph.D. and John E. Hauptert

The nominating committee of most boards was a sleepy place that met once a year to do very little. Today, it is being transformed into a new nominating and governance committee. With a portfolio that can include evaluation, new governance rules, disclosure and risk management, it is now one of the hottest spots in the boardroom.

Today, regulators, investors, analysts, and corporate boards are holding audit committees, the guardian of shareholder value, responsible for making certain that the company performs ethically and efficiently and that its guidance and reports properly reflect the company's financial condition. The audit committee is also now expected to oversee a sizable portion of their firm's corporate governance process. This has placed a much larger and continually expanding burden on the committee's members.

To meet these new demands, audit committees have been strengthened by the addition of outside and more experienced directors. They are expected to put in more time on committee work, and in many companies receive extra pay in recognition of the expanding workload.

A new approach may be needed to provide the necessary oversight of corporate governance in today's highly specialized, global and rapidly changing world.

However, there have been continuing ethical problems at major corporations, and now the housing/liquidity crisis has caught many boards by surprise. It appears that a new approach may be needed to provide the necessary oversight of corporate governance in today's highly specialized, global and rapidly changing world.

Regulators, institutional investors and the plaintiffs' bar continue to demand improved governance and oversight and will quickly assess penalties or begin legal action if they uncover problems, particularly if they reflect governance failures.

In addition, employees who hold their company's stock in defined contribution plans have been ruined financially by failures such as Enron, WorldCom, and Bear Stearns. This group of shareholders is also demanding increased scrutiny of board activities. Such intolerance of poor board oversight may result in legal action against and possibly criminal charges for directors' failure to properly discharge their responsibilities. Boards recognize their vulnerability and are working hard to improve their governance policies and processes.

As a first step, boards have identified issues of major concern. These include: time management, information management, and the need to rely on staff reports without having performed a detailed review of their content. Boards also realize that senior management compensation and the early identification and mitigation of company-threatening risks are issues that must be dealt with.

Obviously, each company deals with these issues in different ways. However, one idea that seems to be gaining traction is the formation of a Nominating/Governance Committee (NGC) that would deal with these major board concerns.

The NGC should be a separate committee with responsibility for nominating board and committee members as well as senior management. Related to this function would be a coordinated effort with the compensation committee to develop a framework for director and senior management pay, including ben-

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efits, bonuses, stock options and restricted stock.

The second area of responsibility would be the establishment, review and continual update of the entire governance process to ensure that it remains effective.

The third area of committee responsibility would be the creation and monitoring of a corporate wide risk analysis program.

A nominating/governance committee could evaluate the need for new board committees and their membership, and determine when a committee's usefulness has ceased.

□ *Nominations for board, committee and senior staff positions.*

The responsibility for nominating directors and senior staff is a key component of the overall governance process, and the key task of a nominating/governance committee. Past practice has been that the nominating committee concentrated primarily on succession planning for the CEO position. This in itself is a very important responsibility. The loss of a CEO, whether due to unforeseen events or planned retirement, usually is a traumatic time for the company, its staff and shareholders.

However, studies have shown that many companies spend little, if any, time on this important issue, and even less on the senior C-suite positions just below the CEO level. This must change, especially since it is becoming more obvious that an experienced and well-balanced senior staff is a major determinant in the success of a company's governance. For that reason, the role of the nominating committee should evolve to include responsibility for regular CEO planning sessions and similar nominating and succession planning for board members, as well as other senior staff, especially the CFO.

A logical extension of the nominating and selection process would be to make certain that the compensation packages for the accepted nominees are appropriate. There is no question the pay of directors and senior staff has become a hot button issue for the media, shareholders, and regulators.

Issues such as backdating of options, outrageous severance pay for executives at companies that have failed or are performing poorly, and the gap between executive salaries and staff have led to calls for litigation, regulation, government intervention and better disclosure. Since this matter is so important in how a company's overall governance is perceived, the NGC should work with the compensation committee to develop a framework that insures that pay packages can be justified.

By working together, the two committees could assure that pay packages can withstand scrutiny by the many constituencies that are looking for corrective action on compensation. They could develop a framework that assures pay is tied to performance, severance packages can be justified, options are handled properly, and benefits are fully disclosed and reasonable. This would go a long way to silence critics of a company's pay practices. The framework should also indicate when it would be desirable to bring in experts (that must be totally independent) to assist with complex pay plans.

The focus on "independent" directors, and the growing awareness of the value of a cross section of skills on a board, has been seen to be one of the factors leading many firms to the creation of nominating/governance committees. The addition of new committees, such as finance, IT and risk analysis, points to another important issue—the size of boards and the amount of time required by directors.

An NGC could take responsibility for the evaluation of the need for new committees, the composition of committee membership, rotation policies for the chair and members, and also determining when a committee's usefulness has ceased. This work would put the NGC in a good position to examine potential candidates for board or senior staff positions as openings occur. The committee would have the background needed to screen candidates based on their experience, technical skills and time availability.

The NGC could also involve itself in controversial issues such as whether the entire board should stand for election each year, if there should be term limits and the degree to which shareholders should

Rethinking The Committee Role

Nominating/Governance Committee Charter Modifications

Sample firms	Charter Modifications							
	1994	1998	2000	2002	2003	2005	2007	2008
Coca Cola	●				●	●		●
General Motors	●	●		●			●	
IBM	●		●					

A review of publicly filed documents provides insight into the work of Coca Cola, General Motors and IBM to address governance issues.

be involved in compensation issues. While on the surface, these seem like good ideas that will produce better and more responsive boards, they may have serious flaws.

For example, if experienced directors are replaced each year with new directors unfamiliar with the company, a major event occurring just after the entire board had changed could be disastrous. Having in place an NGC that understands the functioning of the board and its committees can be invaluable when evaluating and reacting to such proposals suggested by shareholders. Another area that the NGC might be involved with is to evaluate major structural changes that management makes that have a dramatic impact on operations.

Assigning the responsibility for corporate governance to a nominating/governance committee might be a solution to some of the company's ongoing governance difficulties.

□ *Establish, review and continually update the governance process.*

Corporate governance is not easy to define. However, everyone expects that corporations will have a governance process in place that will assure that a corporation performs ethically and for the benefit of its shareholders, operates efficiently, meets legal and regulatory requirements and is a good corporate citizen.

To meet these objectives it is necessary to have in place processes, policies, and written procedures. These make clear what is expected in the way the company is directed, administered and controlled. Corporate governance also focuses on the proper relationship among all those who play a role in governance. These include shareholders, management and the board of directors, employees, consultants, suppliers, customers, creditors, regulators, rating agencies and the community.

Corporations have relied heavily on audit committees and legal staff to establish and oversee corporate processes that will satisfy all the company's stakeholders and there have been significant improvements. Nevertheless, much more work seems to be required. Many problems are still surfacing such as the backdating of options, the subprime mortgage fiasco, and unauthorized trading by employees. There have also been hefty severance payments to CEOs who led their firms into risky ventures that virtually destroyed the firm, seemingly with little regard for employees or shareholders.

Several factors seem to be at work when corporate governance is not working properly. First among these seems to be the failure to set the proper tone at the top. Organizations that fail to make it clear that *everyone* is subject to rules of ethical behavior will have problems. This is especially the case when there is not an adequate set of checks and balances in place and there is not a fair and well-known system to penalize violators.

Consolidation of power is another major threat to proper governance. A CEO with complete control of the board has the ability to control or manipulate others to achieve his goals, which may not always be in the best interest of the company. Finally, the volume of work that boards have become responsible for has created major time and information management problems for members. This has created situations in which directors must rely on management reports without adequate review of the details.

Assigning the responsibility for governance to the nominating/governance committee might be a solution to some of these difficulties. The committee might have a more complete understanding of the relationship of senior staff and directors to the entire governance apparatus. Furthermore, unlike the audit committee, which is responsible for internal controls, financial reporting, and working with audits, the NGC could limit its role to matters more clearly related to governance.

It is important to note, however, that this committee will have a large workload, and it might be necessary to expand the board to properly staff the NGC. It is also important that the NGC not impinge upon the work of other committees, particularly the audit committee.

Nominating/governance committees should develop an operational “code of conduct” for board members and senior management, different from the code of ethics.

The NGC should examine the many aspects of governance on an ongoing basis. For example, it should assure that the company has a sound code of ethics, and set a regular review of the code to see that it remains adequate. It should also insist that the code be distributed to every employee on a regular basis and that supervisors periodically remind their employees of its importance. The company’s mission statement should also emphasize the importance of ethical behavior as spelled out by the code.

The NGC should likewise develop a “code of conduct” for board members and senior manage-

ment. This is an operational code, different from any ethical code that might be in place, and can cover a wide range of matters.

These would include the use of company resources of all types, including airplanes, boats, accommodations (hotel suites, condos, etc.). It would require a listing by each board member and senior manager of any trips, meals or entertainment provided to them by anyone that does business with the firm. There should also be full disclosure of commercial activities between counterparties, such as associated accounting or law firms providing personal tax, advisory or legal services.

Rules should be set to avoid any activity that could lead to the appearance of, or actual, insider trading. At a minimum, there should be full disclosure of transactions in the company’s stock. To help monitor and control possible malfeasance, the NGC might seek agreement to provide telephone records or other useful information should it be needed for internal or external investigations.

The nominating/governance committee should also monitor director participation at meetings of both the board and committees. As stated earlier, time management is critical in today’s corporate world, and it is imperative that directors have enough time to do the work required. It is important that there are clear guidelines as to whether, or how many, other boards directors may represent, and whether those in key positions at other firms will have the time required. Guidelines should be established for required participation and mechanics put in place for removing directors that cannot fulfill their duties.

The code of conduct should also lay out guidelines for directors and senior staff dealing with employees. Favoritism should be avoided and every employee should be treated equally, without regard to race or gender. There should be a method for employees to communicate with senior staff and directors, particularly if they wish to report violations of the codes of ethics or conduct. The NGC would be a place for this communication to be handled.

Many corporations undergo restructurings intended to improve their performance. During these restructurings, management often must focus on shuffling or

eliminating employees, new financing, selling pieces of the company or integrating acquisitions. Little thought is given to the impact on the governance process during the restructuring, or how it should change when the restructuring is completed.

The NGC is a good place to start when considering how to manage these difficult situations. Of course, a default under any financial or operational agreement would require immediate attention. Any governance changes may need to be vetted by a board committee such as the NGC prior to implementation.

The information overload faced by directors is another problem that must be dealt with to ensure proper oversight. The NGC can look into this matter and develop ideas for making sure the board and its committees review only major matters and delegate less sensitive items and those with less financial impact to senior staff. Guidelines can be developed for the depth of review given to complex management proposals, including when and how outside experts can assist in such reviews. The NGC can also consider transparency needs in the board minutes.

Finally, there may be instances when ad hoc committees are needed to handle sensitive matters. The NGC can work out the mechanics for organizing and assisting such special committees.

The role of overseeing the risk analysis program would also be a good fit for the nominating/governance committee.

□ *Creating and monitoring a corporate-wide risk analysis program.*

Corporations have been managing risk for a long time, using safety programs and insurance coverage to eliminate or mitigate risks. These programs were largely directed toward the loss of property, business interruption, or liability for personal injury or damage to property. There have been attempts to widen risk analysis to assure that every possible risk to the company is considered.

The recent fiasco with sub-prime mortgages led to billions of dollars in losses to companies that were thought to have excellent risk controls. This has

provided additional motivation for improved risk analysis. Many companies are now considering the appointment of a senior staff member who would examine every business area, and work with the head of the area to identify every threat facing the company. Potential losses and damages arising from these threats would be estimated and suggestions to prevent or mitigate them developed.

The person responsible for risk analysis would need to work with many people throughout the organization and coordinate the effort with the internal audit, legal and insurance staff. This work would require constant updating, and would identify all risks and how they are to be handled. The goal would be to assure the board that every effort has been made to protect the company and its shareholders against losses that might have been prevented or mitigated by defensive planning.

The nominating/governance committee might be the logical body to oversee this effort. Clearly, the prevention of financial losses, damage to reputations, employee malfeasance, and legal actions is a prime goal of corporate governance. Thus, it seems the role of overseeing the risk analysis program would be a good fit for the NGC. A committee of this stature, constantly updated on potential risks and ways to handle them, would be a tremendous asset protecting the board in any situation where claims are made that it did not provide proper oversight.

The formation and operation of a nominating/governance committee offers many opportunities to improve the way many governance matters are handled, and could provide a very good defense against charges that boards did not provide for good corporate governance. Clearly, the NGC is not the only vehicle that can be used to improve governance, but it is a means that should be considered.

It must be reiterated that, to do the job properly, experienced people with the time to do the job are essential to such a committee, even if this means expanding the board. Furthermore, directors on this committee must not be seen as another layer of management, but rather a segment of the board working cooperatively with every other board committee to the benefit of all company stakeholders. ■

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