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Board Evaluation Processes and Related Disclosures

In her regular column on corporate governance issues, Holly Gregory discusses recent guidance on shareholder expectations regarding disclosure of board evaluation practices and results, and how board evaluations are undertaken.

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Shareholders of publicly traded US companies have significant interest in the quality of portfolio company governance, yet have limited information with which to assess board performance. Transparency into board composition, structure, and processes has improved through expanded proxy statement and website disclosure since the enactment of the Sarbanes-Oxley Act of 2002 (SOX) and related changes in listing rules. However, critical governance qualities, such as board culture, the board's relationship with management, the style and effectiveness of board leadership, information flow to the board, and the depth of board deliberations, remain opaque.

Boards remain largely immune to shareholder assessment and therefore control efforts to improve how they function. The Council of Institutional Investors (CII) is leading an effort to provide insight into the boardroom through greater disclosure of how the board evaluates the performance of the board, board committees, and individual directors, and how it then uses evaluation results to improve. In light of the call for greater disclosure, boards and their advisors should review evaluation processes and align them, where appropriate, with shareholder expectations.

PRESSURE FOR GREATER DISCLOSURE

CII, through its CII Research and Education Fund subsidiary, recently issued a guide to disclosure of board evaluation processes (CII Guide) to encourage enhanced disclosure around board self-evaluation and endorse certain evaluation processes (Glenn Davis & Brandon Whitehill, CII Research & Educ. Fund, Board Evaluation Disclosure (Jan. 2019), available at *ciiref.org*). The CII Guide follows on an earlier CII report that emphasized shareholder interest in more information about board evaluation processes and provided examples from 2013 and 2014 US and non-US proxy statements of "best-in-class" disclosure relating to board evaluation mechanics and key takeaways from the evaluation process (CII, Best Disclosure: Board Evaluation, at 1 (Sept. 2014), available at *cii.org*).

Since publication of the earlier CII report, disclosure of board evaluation processes has become more prevalent in the US. For example, EY found that 93% of proxy statements filed by Fortune 100 companies in 2018 provided at least some substantive disclosure about their board evaluation processes (EY Center for Board Matters, Improving Board Performance Through Effective Evaluation, at 1 (Oct. 2018), available at *ey.com* (EY Study)).

According to CII, boards should consider and communicate in their disclosure certain indicators of effective board evaluation, which "are not intended to be prescriptive recommendations, but rather descriptive observations of ... disclosure that is particularly effective at building investor confidence that a robust process exists" (CII Guide, at 3). Boards and their advisors should consider these indicators both in designing evaluations and in disclosing evaluation processes, while maintaining flexibility to adopt the processes that meet their own unique needs and circumstances. The indicators include:

- **Three-tiered review.** To be effective, evaluation processes should assess the performance of not only the board and board committees, which is standard practice, but also individual directors, which is less common. The CII Guide recognizes that evaluation processes and disclosure may vary depending on the tier under review: "Thoughtful disclosure conveys the degree of rigidity or flexibility of the evaluation at different levels of review. For instance, the board and committee level assessments might involve more formal practices, such as written questionnaires, while leaving some flexibility in gathering individual feedback, such as conversational interviews." (CII Guide, at 3-4.)
- **Peer review.** The CII Guide emphasizes that, to be effective, evaluation disclosure should indicate that the board at least considered having directors review their peers on an anonymous basis. Individual director evaluation, including peer review "if deemed appropriate for a given company, ... can help ensure that each individual director is accountable to shareholders and enhances the board's desired qualifications and composition." While calling for disclosure of the board's consideration of, and if adopted its approach to, individual director evaluation, the CII Guide also accepts that some companies may determine not to make peer review part of their evaluation processes. (CII Guide, at 4.) According to EY, 24% of Fortune 100 companies that filed proxy statements in 2018 disclosed that they included individual director self-evaluation along with board and committee evaluation, and only 10% disclosed that the individual director evaluation was based on peer review (EY Study, at 2).
- **Timing and format.** The CII Guide recognizes that most boards conduct a formal annual evaluation, and that both timing and format vary. Some boards also solicit feedback from directors throughout the year, for example, through conversations between individual directors and board leaders. (EY found that just under 10% of Fortune 100 companies that filed proxy statements in 2018 disclosed that phases of the evaluation process are carried out on an ongoing basis, at every regular in-person meeting, quarterly, biannually, or otherwise throughout the year (EY Study, at 5).)

  Disclosure regarding both formal and informal processes is important. The CII Guide emphasizes that evaluation should not become "perfunctory," suggesting that boards "actively consider how to improve their evaluation timing and format from year to year." Proxy disclosure should address evaluation timing, as well as the specific format used to gather feedback, such as questionnaires, interviews, and group discussions. (CII Guide, at 4-5.)
- **Follow-through.** The CII Guide advocates that proxy disclosure include "examples of specific actions taken and changes made internally in direct response to previous evaluations" so that shareholders can have confidence that the evaluation feedback translates into action. It also notes that "[e]specially strong disclosure draws connections between changes implemented as a result of evaluations and the company's overall strategic objectives."

  For many boards and their advisors, this is a controversial recommendation. Public disclosure of evaluation findings may lessen the likelihood that directors will be self-critical in providing feedback about board, committee, and individual director performance. Shareholder pressure for this disclosure could have the unintended consequence of chilling robust reflection and discussion, thereby depriving boards of the opportunity for meaningful improvement efforts.

  While the CII Guide recognizes the need to avoid revealing confidential or proprietary information in evaluation disclosure, it does not address the significant concern that disclosure of concrete actions taken could discourage both self-critique and the actions that may come from this critique. As a result, disclosure in this area may tend to focus more on future board composition needs in light of strategic direction and the adoption of meeting process "best practices" than on sensitive issues relating to board culture, board-management relations, and individual director performance. (For examples of high-level disclosure of actions taken by Fortune 100 proxy filers as a result of board evaluations, see EY Study, at 5.)

The CII Guide also calls for boards to disclose "whether there is a role for shareholder engagement in assessing board effectiveness and enhancing procedures in the evaluation process." Boards may wish to add board evaluation as a topic for shareholder engagement, using the opportunity to seek feedback from shareholders on the evaluation process.

(CII Guide, at 5.)

- **Succession planning.** According to the CII Guide, board evaluation disclosure should assist shareholders in making informed voting decisions in director elections by showing "ongoing attention" to board composition and "a willingness to change" to accommodate new skills or insights if needed. The evaluation process should provide the opportunity for "difficult, candid conversations" regarding each of the three evaluation tiers. For example, the CII Guide urges boards to disclose instances in which the evaluation process prompted a decision not to re-nominate an incumbent director, including the rationale supporting the conclusion that the director should retire, and the skills sought in a new nominee. (CII Guide, at 5-6.)

  However, a decision not to re-nominate a director, for example, due to underperformance or a skill set that is no longer relevant, is highly sensitive. Pressure for disclosure of these sensitive decisions (beyond what is currently required in a Form 8-K and proxy statement) may heighten resistance to individual director evaluation or result in a less robust evaluation.
- **Independent leadership.** The CII Guide advocates that an independent board leader (independent chair or lead director) play a prominent role in the evaluation process and that disclosure provide information about how that board leader "filters information and insights across multiple levels and facilitates one-on-one discussions with individual directors." (CII Guide, at 6.) According to EY, a significant majority (69%) of Fortune 100 companies that filed proxy statements in 2018 disclosed that their nominating and governance committee performed a key role in the evaluation process, either alone or with a board leader (EY Study, at 2). However, the CII Guide appears to relegate the chair of the nominating and governance committee (when that chair is not also the independent board leader) to a supporting role with the committee in structuring the evaluation process and in connecting the evaluation process to director re-nomination decisions. It is unclear from the CII Guide whether this is intended to be normative and, if so, why. At some companies, the chair of the nominating and governance committee leads the evaluation effort, including the evaluation of the independent board leader.
- **Use of third parties and technology.** The CII Guide recommends that proxy disclosure cover whether the board considered using independent third parties or technology platforms to enhance the evaluation process, while recognizing that boards will come to different determinations about whether to use such resources. Relevant considerations include the potential discoverability of evaluation records in litigation (the involvement of counsel may assist in protecting these records), support of director anonymity, and provision of candid feedback. According to EY, 22% of Fortune 100 companies that filed proxies in 2018 disclosed using or considering the use of an independent third party to facilitate the evaluation at least periodically. (CII Guide, at 7; EY Study, at 6.)

The pressure for more disclosure regarding board, committee, and individual director evaluation processes is likely to continue to increase. Therefore, boards and their advisors should reconsider evaluation processes. For example, the board should assess how its approach to board, committee, and individual director evaluation and the related proxy statement disclosure compares to the expectations outlined in the CII Guide and to the disclosure of its peers. This comparison may highlight changes to consider in the approach, the disclosure, or both. The board should determine whether any differing practices are justified based on its circumstances and needs.

The board should also consider whether its approach to evaluation provides quality feedback that helps it identify and act on areas where board and committee performance can be improved, and whether individual directors receive feedback that enables them to improve their contributions to board and committee decision-making. The board should confirm that the nominating and governance committee considers both individual director performance and the alignment of directors' skill sets and expertise with changes in the company's strategic direction and other needs when making decisions to recommend re-nomination of directors. (According to PwC's 2018 Annual Corporate Directors Survey (available at *pwc.com*), 45% of directors think at least one person on their board should be replaced.)

Search Issues to Consider Before Conducting a Board Evaluation: Checklist for more on the key issues that a company and its board should consider in formulating the board evaluation process.

STRUCTURING BOARD EVALUATIONS

Board evaluation is a tool to help boards avoid stasis and continuously self-improve. To benefit from the evaluation effort, a rote compliance-focused approach must be avoided. Adjusting the scope and methodology from time to time helps keep evaluation efforts meaningful, and given the heightened emphasis by shareholders on disclosure, a renewed focus on appropriate board evaluation processes is prudent. In particular, boards that do not yet assess the performance of individual directors should reassess their approach. Whatever the scope of the evaluation efforts and the methods used, the goal should be thoughtful consideration of areas for performance enhancement.

Before enactment of SOX and the related reform of listing standards, board evaluation was still an emerging best practice among the boards of S&P 500 companies. Annual board evaluation has gained considerable traction since then. The New York Stock Exchange Listed Company Manual Section 303A.09 and Commentary (NYSE Listing Rules) require boards of listed companies to address board evaluation in corporate governance guidelines and require that audit, compensation, and nominating and governance committee charters also provide for committee evaluation. The NYSE Listing Rules also recommend that "[t]he board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively." (Companies listed on Nasdaq do not have similar requirements, but many still engage in self-evaluation as a matter of good governance practice.) In addition, independent auditors often ask about the board's evaluation processes as part of the auditor's assessment of the internal control environment.

According to the 2018 US Spencer Stuart Board Index (available at *spencerstuart.com*), 98% of S&P 500 companies undertake some form of annual board evaluation. Of these companies:

- 54% evaluate the full board and committees.
- 35% evaluate the full board, committees, and individual directors.
- 8% evaluate the full board only.
- 3% evaluate the full board and individual directors.

Search Audit Committee Self-Evaluation, Compensation Committee Self-Evaluation, and Nominating and Corporate Governance Committee Self-Evaluation for model questionnaires for the self-evaluation of board committees, with explanatory notes and drafting tips.

BOARD AND COMMITTEE EVALUATION

Evaluation provides the board and its committees with the opportunity to consider how group culture, cohesiveness, composition, leadership, and related meeting and information processes and governance policies influence performance. In addition to identifying areas for potential adjustment, evaluation reminds directors of the importance of group dynamics and effective board and committee processes in fulfilling board and committee responsibilities. While the most effective evaluation processes are tailored to the specific needs and objectives of a company, common elements include:

- **Authority.** Typically, the nominating and governance committee and/or the lead director or independent chair is delegated the task of developing and implementing an evaluation process.
- **A defined objective.** The objective of the evaluation should be defined with some specificity. The board should consider:
  - whether the evaluation is being undertaken simply to comply with listing rules and best practice, or whether there are specific areas that warrant attention. For example, the timing may be ripe for the board to examine how it engages in strategy or risk assessment, or selects the board leader;
  - whether there have been significant changes on the board that increase interest in working on board culture and alignment with management;
  - whether there are any underlying concerns about how the board is functioning;
  - what a successful outcome would be, for example, stimulating general ideas about process improvements and confirming that the board generally believes it is effective, emphasizing governance roles and expectations, enhancing consensus about governing approach, or committing to compositional change; and
  - whether there are issues that the board will be sensitive about exploring and, if so, why.
- **Determination of the scope.** The defined objective assists the board in determining the scope of the evaluation, regarding both the subject of the evaluation effort (for example, the board as a whole, committees, individual directors, or all of these) and the topics to address.
- **Identification of participants.** The defined objective assists the board in identifying the individuals who will be asked to participate in the evaluation and provide their viewpoints. Presumably this includes directors with respect to board evaluation and committee members with respect to committee evaluation. In addition, key members of management may be invited to participate. As to individual director evaluation, individuals may be asked to self-assess or assess their peers. The board should consider whether to seek assistance from a third-party facilitator or whether the committee chair, lead director, general counsel, corporate secretary, or another insider will assist. A third party is often relied on to assist in tailoring areas for inquiry, collecting and collating information from surveys and interviews, and facilitating discussion. Using an attorney may preserve the ability to argue at a later date that attorney-client privilege attaches. However, the strength of this argument has not been tested, and boards and committees should not rely on this protection. (This leads some boards and committees to rely solely on paperless facilitated discussions.)
- **Tool selection.** The evaluation process typically involves obtaining viewpoints about board, committee, or individual director performance using either surveys or interviews. Viewpoints can also be obtained through a more streamlined process involving a facilitated board or committee discussion. Written surveys provide an efficient means of obtaining viewpoints while providing confidentiality, although they may not elicit a full explanation of a particular viewpoint. Typical surveys include questions that can be answered with standardized responses, as well as open-ended questions and areas for comment. Interviews take more time, but provide the opportunity to explore viewpoints more fully, because questions are open-ended and the interviewer can explore issues raised in detail. Facilitated discussion provides the opportunity for directors and committee members to share viewpoints, discuss potential modifications to governance practices in response to concerns that are identified, reach consensus, and resolve underlying tensions. While facilitated discussion can be used alone to streamline the entire process, if used without a survey or interview process it does not provide the opportunity for confidential input. If written surveys are used, the board should be aware that these materials may be sought in litigation discovery proceedings.

Generally, the underlying "raw" evaluation materials, such as surveys and interview notes, are not retained after the results have been compiled. These methods can be combined. For example, a survey or interview format may be used to obtain information in a manner that protects confidences, followed by a facilitated discussion, or a survey may be sent out with follow-up in brief interviews, culminating in a facilitated discussion. To keep the evaluation fresh, both the process for obtaining input and the specific questions should be changed from time to time.

- **Culture.** In designing the evaluation process, consideration should be given to the board's culture and how to encourage trust among participants. Where factions are already apparent, special efforts may be needed to design an appropriate process to achieve consensus.
- **Analysis and discussion.** The information obtained from surveys and interviews is collected and analyzed in a written or oral report that is designed to stimulate a full board or committee discussion of the results. Whatever format is used, the evaluation should culminate in deliberation and discussion about how the board and the committees can improve their function. For individual director evaluations, results may be presented in a report or in an individual meeting.
- **Action.** The board should use the feedback from evaluations to resolve issues, make changes, and achieve goals. If discussion leads to consensus about areas in which changes might be beneficial, appropriate follow-up is important. This may involve delegation of further study or other work and implementation to the nominating and governance committee, or to another committee or management. Minutes should reflect simply that the evaluation was undertaken (unless there is a clear action item, such as "it was agreed that the nominating and governance committee should review and recommend to the board ____.").

THE EVALUATION FRAMEWORK

Most board and committee evaluations are intended to assist in identifying areas in which performance can be improved so that performance issues may be addressed. Some boards may have other more targeted goals, and the focus of the evaluation should be adjusted to those goals. Evaluations also provide an opportunity to survey directors about the issues that they believe should receive more attention in board and committee meetings and in the materials presented both prior to and in meetings. Most board and committee evaluations cover:

- **Composition and leadership.** This involves assessment of whether the board and its committees have the appropriate composition to address the governance needs of the company currently and in the foreseeable future, and whether the leadership of the board and its committees is effective.
- **Refreshment mechanisms.** This involves assessment of whether the board:
  - has appropriate refreshment mechanisms in place;
  - is overly reliant on age limits;
  - makes active (or fairly rote) re-nomination decisions;
  - evaluates individual directors with some degree of rigor and provides feedback so that individuals can improve; and
  - considers evaluations in re-nomination decisions.
- **Focus (agenda) and information.** This involves assessment of whether the board and its committees agree on what the most important issues facing the company are, focus appropriately on these issues, have the information needed to make informed decisions, and make these decisions in a timely manner.
- **Culture.** This involves assessment of whether the board has created a culture that puts the company's interests above the interests of directors (including their interest in re-nomination) and values informed discussion of diverse views, constructive disagreement and debate, timely resolution of issues, and appropriate handling of conflicts. The quality of the board's relationship with management, key advisors, and shareholders, as well as the directors' relationships with each other, is also relevant.
- **Governance structures and practices.** This involves assessment of whether the board has created a set of governance structures and practices that supports its ability to govern effectively and objectively.

Search Board Self-Evaluation for a model questionnaire for the self-evaluation of a company's board, with explanatory notes and drafting tips.

INDIVIDUAL DIRECTOR EVALUATION

Individual director evaluation remains a minority practice among large companies. Only 38% of S&P 500 companies report that they evaluate individual directors, according to the 2018 US Spencer Stuart Board Index.

Emphasis on evaluating board and committee performance is appropriate given the collective nature of board and committee decision-making authority. At the same time, the foundation for effective collective decision-making is the engagement, understanding, and efforts of individual directors, and therefore individual director assessment complements the board and committee evaluation process. Individual director evaluation encourages self-reflection and can assist directors in identifying and addressing individual behaviors that may improve group dynamics and performance. In addition, formal evaluation of individual directors can help support the re-nomination decision process by providing a sense of due process and internal transparency.

Evaluation of the board and its committees requires some consideration of the contributions of individual directors to the ability of the decision-making body to perform effectively. While it is relatively common for board and committee evaluations to include general assessments of the participation and preparedness of directors, many boards hesitate to evaluate individual directors as a component of the annual evaluation process. This is an area worth reconsidering when contemplating how to refresh an approach to board and committee evaluation. Even short of undertaking detailed individual director self-evaluation and peer evaluation, some expanded consideration of the contributions of individuals may provide valuable insights into areas for improvement.

Director evaluation can underscore performance expectations, help directors consider their own contributions, and provide directors with feedback that they can use to improve performance. Individual directors bring very different experiences and competencies to the board, so evaluations tend to be based on general and observable criteria, recognizing that directors contribute in varying ways in board meetings, committee meetings, and outside of the boardroom.

As with board and committee evaluations, a range of approaches are available, including:

- **Open-ended questions.** These can be added to a board evaluation, either in interview or survey form, to elicit comments about the contributions of individual directors.
- **Self-assessment.** Each director provides a self-assessment, typically through a written survey. This approach offers an opportunity for self-reflection. It is also sometimes used as an initial step toward implementing a broader peer evaluation process.
- **Peer evaluation.** Each director provides a self-assessment and an anonymous peer review of each fellow director, typically through either an interview or open-ended questions (although given the number of directors that each director must assess, comments on open-ended questions tend to be limited). Some boards use a written survey in which each director provides numerical ratings of all fellow directors. However, care needs to be taken with ratings to ensure that all directors understand that numerical values can lead to a perceived ranking of "best" and "worst" even though the differences in ratings may be very small.

Typically, the nominating and governance committee determines the parameters to be assessed, addressing the essential responsibilities of an effective director in terms of observable behavior, recognizing that each director contributes a unique set of experiences and competencies. These parameters normally include:

- **Commitment.** This means the director:
  - attends and actively participates in meetings and is appropriately prepared and informed;
  - is generally available as needed for special meetings; and
  - stays up to date with information about the company's business, market and regulatory developments, and other bodies of relevant knowledge.
- **Fiduciary duty.** This means the director:
  - understands his or her legal obligations to the company and its shareholders;
  - is objective and willing and able to challenge management constructively as appropriate, while respecting the line between oversight and management;
  - is effective in expressing viewpoints; and
  - follows up regarding areas of concern.
- **Contribution.** This means the director:
  - provides constructive criticism and thoughtful recommendations and generally exhibits good judgment;
  - brings special skills, unique knowledge, or other special qualities to the board;
  - displays conduct that engenders mutual trust and respect within the board; and
  - listens to others.

These topics can be expanded as appropriate. Often it can be helpful to ask directors to provide actionable suggestions about ways in which other directors can improve their performance, for example, by completing the following statement: "This director could be even more effective if ____."

As with full board and committee evaluations, a trusted third party often facilitates peer evaluations, serving as a neutral and confidential conduit for the receipt, compilation, and summary of evaluation results. A composite report of the feedback received is then provided to each director orally or in writing for the director to consider. If significant performance issues are identified, they should be considered by the board chair, lead director, nominating and governance committee, or all of these, as appropriate, to determine whether coaching, additional education opportunities, or other support for the director is appropriate, or whether consideration should be given to ending board service, for example, through a determination not to re-nominate the director.

A board may consider implementing individual director evaluation in stages. For example, a first stage could be simple self-assessment to encourage self-reflection on the qualities and criteria that the board, through the nominating and governance committee, has decided to focus on. Peer evaluation can be added later, but with an understanding that results will only be provided to the subject director. This may increase directors' comfort with the process, because they will have the opportunity to consider feedback and take action to change any perceived problems. In a later stage of implementation, the board chair, lead director, nominating and governance committee, or all of these would receive a report identifying significant outliers or issues. In determining how to implement individual director evaluation, consideration should be given to developing an approach that is most likely to encourage candor and constructive feedback.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.