

Your Board: Dynamic or Dysfunctional?



By Verne Sedlacek

In the wake of Enron, WorldCom, Adelphia and others, governing boards are in the spotlight.

Granted, nonprofits are different.

But, they're not immune from some of the same woes that befell their corporate counterparts.

Now's the time to act.

The biggest news from the corporate world over the two past years wasn't to be found on the business page, but on the front page: CEOs arrested in public. The integrity of reputable audit firms suddenly sullied. CFOs sweating out grillings by members of the U.S. Senate. Big financial firms scrambling to explain complex trading deals of questionable value and marginal benefit (except to themselves and a few highly-placed corporate clients). Mutual Fund complexes with household names removing high-ranking officials and paying hundreds of millions of dollars in fines.

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None of this has spilled over yet to the not-for-profit world — not directly, at least. But, nonprofits are not immune from their own episodes of mismanagement and private infighting as well as the risk of governance issues flaring into a public spectacle. There have been several instances in recent years of battles between university presidents and their institutions' boards erupting into media events — and sometimes ending in litigation.

These very high profile public failures in corporate governance have resulted in an intense focus at all levels on how boards should operate. Congress (via the Sarbanes-Oxley Act of 2002), the SEC, the New York Stock Exchange and NASDAQ have all weighed in on the issues of good corporate governance. While these pronouncements do not directly affect nonprofit boards (at least not yet) they include a number of standards that will help define “best practices” going forward. It is worth pointing out that the Attorney General of the State of New York, Elliot Spitzer, has proposed legislation that would require nonprofit organizations chartered in New York to adopt certain governance reforms similar to those required by Sarbanes-Oxley. In California a new law effective January 1, 2005, outlines specific governance requirements for charities.

All of this makes it an appropriate time to reflect on issues related to nonprofit governance and to map a course of action for making sure one's house — be it educational institution, foundation, healthcare organization or operating charity — is in

order. This is not an easy task. Personalities, power and priorities — not to mention money — are all wrapped into a potentially volatile mix that can blunt the best-intended efforts to implement needed reforms. That makes it all the more important to contemplate well-considered steps that can be put into effect in an orderly manner.

The question is, what actions? In this article, I would like to offer a short list of touch points that, in my opinion, should be included in any thoughtful analysis of a nonprofit institution's philosophy, policy and practice. These are questions of:

- Board structure (including size)
- People (including board composition)
- Relationships (chiefly, the need for independence)
- Compensation (should nonprofit board members, particularly investment committee members, be compensated?)
- Roles and responsibilities (principally the key committees and board chair)

Although this is not a comprehensive approach to governance — a subject that would fill a good-sized book — the topic is important to discuss because poor governance is an insidious disease. Frequently, there are no symptoms — until the situation is acute. There isn't a checklist that one can easily consult. That said, there are some signs to heed, for instance: board members who are neither engaged nor involved; a generally dispirited board; too many committees; allocation of valuable board time to reviewing

committee reports; an overall lack of strategic direction; and focus on lower level detail. If any of these signs seem familiar, you may be well advised to tackle the problem now — before it gets bigger and tougher. Let's turn to points of which boards should be aware.

STRUCTURE

While Congress (through the Sarbanes-Oxley Act of 2002), the New York Stock Exchange and the SEC are all addressing issues of corporate governance, one can't simply regulate good nonprofit governance. But a good place to start is board structure.

To begin, a thought on size: The trend today is toward smaller boards with more actively engaged members. Boards of 24, 30 or more people are simply unwieldy and tend to disperse responsibility. Dispersed responsibility is a real issue. Large boards can lead to abdication of responsibility, as board members each assume that someone else is steering the ship. Yet, boards can grow to that size because of a desire to recognize important donors, ties with local and regional business and civic affairs leaders, and, in the case of educational institutions, the desire to recognize distinguished alumni. Large boards encounter difficulty making decisions or coming to conclusions. They become a group of men and women in which everybody has an interest and nobody has a direct responsibility. The consensus orientation that characterizes large boards blunts crisp decision making and leads to less-than-optimal outcomes. If board members are donors, they may become frustrated because they don't have a voice.

Boards that are too large have another problem — a tendency to proliferate committees, a situation that gets in the way of communications and continuity. Yet there are three committees that should be central to the integrity of every board. Those committees are audit, compensation and governance. I'll address the audit committee separately in "Roles and Responsibilities;" for now, let me speak to the compensation and governance committees.

The compensation committee is charged with determining compensation for the senior officers of the organization and how that compensation is structured. Because of the nature of the compensation committee's decisions, a large majority of its members should be independent of management, and the independent members should be the final determiners of senior management compensation.

The recent announcement by the Internal Revenue Service that they would begin looking at non-profit compensation elevates the importance of this committee. The process for setting the compensation of senior management will come under higher levels of scrutiny. In the case of compensation, a clearly articulated and documented process by truly independent Board Members, with examinations of levels relative to the market, will reduce the possibility of problems. The governance or nominating committee has the responsibility of evaluating current trustees, selecting and interviewing future trustees, and being certain that committees are staffed with the right mix of people.

Again, independence is vitally important. The nominating function is a traditional one on

most boards, but the governance committee goes beyond nominating because it includes an evaluation function. Nominating a new member is important, indeed; however, ensuring that board members and committees are evaluated and steps are taken to deal with problems is critical to the long-term health of a board. This process is often overlooked in effective board management. The governance committee should also be responsible for making determinations of the independence of trustees and committee members.

One alternative to a burgeoning number of committees is the formation of task forces (or subcommittees) to address specific issues. If they are established with sunset provisions, they do not take on a life of their own. A good example of this would be an information technology group staffed with experienced MIS professionals (and others) for the expressed purpose of recommending an IT policy and implementation plan to the board.

PEOPLE

Every entity may be different in terms of having “the right” people, but I believe one starts with board composition and making certain the mix is complementary in terms of members’ skill sets. An educator, a financial executive, an investment professional, a lawyer and a technology expert would each contribute from the perspective of their own sphere of knowledge and experience. That kind of diversity is a strength. On the other hand, having all lawyers or investment experts on the board risks a very narrow perspective. In my own experience, some of the best questions about investment policy and

financial management come from non-financial board members.

Increasingly today, a related issue is the number of boards on which a trustee serves (a question for the governance committee to address). Can one effectively devote the time, energy and focus needed when serving on, say, five boards? Quite frankly, not-for-profit boards can be more time-consuming than the boards of for-profit enterprises. Again, speaking from personal experience, not-for-profit boards can be all-consuming when it comes to time — you put your toe in the water and the next thing you know you’re in up to your neck.

The last but most important point to make about board member selection is personal integrity. This is often the hardest aspect of a board member to evaluate, but it is often the key to having an effective board. A recent article by Joseph Fuller and Michael C. Jensen of the Monitor Company and Harvard Business School sums up the notion perfectly: “Honesty and integrity in our actions and words are most valuable to others where it costs us something to adhere to them.” Promulgating complex rules and narrowly defining oversight functions do not by themselves encompass the broader notion that integrity is about one’s actions where those actions come at a cost.

ROLES AND RESPONSIBILITIES

Earlier, I mentioned three vitally important committees. Let me return to the third of those committees, the audit committee. On the issue of independence, there can be no question: The audit committee must be

completely independent and include no corporate officers. At the very least, the audit committee should be responsible for evaluating auditors and evaluating the organization's financial controls. If there is an internal audit department, the committee should establish the overall priorities and operating guidelines of that department. And committee members need to spend time with the auditors without the presence of management.

Accounting standards, the responsibilities of the audit committee, the services of public accounting firms and internal controls were the primary focus of the Sarbanes-Oxley Act of 2002. Although this legislation addresses public corporations, I recommend that chairs of nonprofit boards, audit committee members and others become familiar with its language and intent. That is precisely what we did at Commonfund, and Norman Herbert, the chair of our audit committee, found it to be an extremely useful framework for examining policies and practices and recommending improvements.

A brief comment on roles and responsibilities as it relates to the board chair: Boards should consider insisting that the chair remain a non-executive position. This is a major issue that hasn't been addressed yet in the corporate world, and one in which the not-for-profit world is well ahead of the for-profit world. There may be examples of not-for-profit boards with chair persons who are also the institution's CEO, but I can't find any. In the U.S. corporate world, combining the CEO and board chair positions is the prevailing model. Not so in Europe, where the roles are

usually separated. Once again, the core issue is one of independence. Given this separation of powers, boards have the opportunity to meet in executive session to review the performance of the chief executive and his or her senior staff, and they should take advantage of it.

COMPENSATION

Today, a vast majority of nonprofit trustees serve without compensation. As part of the overall review of corporate governance practices, nonprofits should at least consider whether some compensation for board members makes sense.

Historically, trustees, even on the high-profile investment and audit committees, have performed pro bono work. These trustees provide valuable services because of their dedication to their institution. However, with the movement underway to increase the responsibility and obligations of boards, even in the nonprofit world, an evaluation of some form of compensation should be considered. This may be a fairly radical concept, but I have seen it used effectively both at Commonfund and Harvard Management Company.

In considering whether institutions should compensate trustees, several questions should be addressed:

- What is the work load of the trustee with respect to time and effort, particularly with committees such as audit and investment?
- What are the potential liabilities and obligations of the board members?

- With the sea change in for-profit corporate governance, do trustees continue to have the time to serve on a large number of for profit and nonprofit boards?
- Since having the right trustees is important, does some form of compensation allow for the ability to attract the best trustees?
- Will compensation change the dynamics of board operations?
- What is the cost of implementing such a system? As nonprofits continue to struggle with budget challenges, does trustee compensation create the proper perceptions and how will it impact the nonprofit finances?

The current environment will continue to present challenges to all involved in corporate governance. Nonprofit boards must continue to think outside the box in order to attract and engage the best trustees. While compensation of trustees may be novel, nonprofit institutions should, at a minimum, put it on the list of things to consider.

INDEPENDENCE

Board independence is clearly one of the most important lessons to emerge from the recent corporate debacles. The board is there to oversee management, so a majority of its members should be independent. I believe that independence should be defined principally in terms of economic relationships and interlocking or overlapping

responsibilities. You're familiar with the old scenario: "You determine my compensation on this board and I'll be on your board to determine your compensation." That type of arrangement would be considered unacceptable by most nonprofit boards, whereas the presence on the board of a lawyer who makes considerable fee income from the institution frequently is not. Such a trustee may make substantial contributions, but the board should include a powerful majority, independent of such ties. What about donors? Should someone who gives money be considered independent?

Yes — simply giving money to an organization does not undermine independence. But, if there is also a substantial economic relationship, that independence comes into question.

Two thoughts on independence: One, I believe that a majority of the board should be independent trustees. Only a clear majority, not 50-50, will do. Two, anyone who does substantial business with the nonprofit institution, or is a former member of management, should not be considered independent.

WHAT CAN BE DONE ABOUT DYSFUNCTIONAL BOARDS?

It is often very easy to see problems with boards and the way they function. It is more difficult to fix those problems. One thing is abundantly clear: Management should not have a major role in making substantial changes to board structure or responsibilities. The non-executive chair should be the key driver of important changes.

If changes to the board structure are seen as necessary, today's intense governance environment should present an excellent opportunity to initiate a review. Commonfund has spent a substantial amount of board and committee time reevaluating our board structure and responsibilities. The ideal place to focus the effort is in one of the independent committees, normally the governance or the audit committee. I have seen both work well in the past. The process that the designated committee should undertake begins with outlining the key aspects of corporate governance that have come out of current best practices. That outline should be used as a basis for beginning the discussions of how to make changes.

SUMMARY

In the wake of corporate misbehavior — even outright criminality — new legislation and regulatory agency oversight are the agents of sweeping change in the way for-profit corporations are governed. Today there is a high level of awareness and sensitivity to issues of ethics, integrity, objectivity and “best practices”, both in the nonprofit institution's boardroom and among the institution's varied constituencies. Now is an ideal time for boards to undertake serious study of their own governance, with the objective of tightening up policies, rules and procedures.

About Commonfund Institute

Commonfund Institute was founded to house the education and research activities of Commonfund and to provide the entire nonprofit community with investment information and professional development programs. Commonfund Institute is dedicated to the advancement of investment knowledge and the promotion of best practices in financial management. Commonfund Institute provides a wide variety of resources, including conferences, seminars and roundtables on topics such as endowments and treasury management; proprietary and third-party research and publications including the annual Commonfund Benchmarks Study; and events such as the annual Commonfund Endowment Institute and the Commonfund Prize for the best contribution to endowment investment research. Its broad range of programs and services are designed to serve financial practitioners, fiduciaries and scholars.

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