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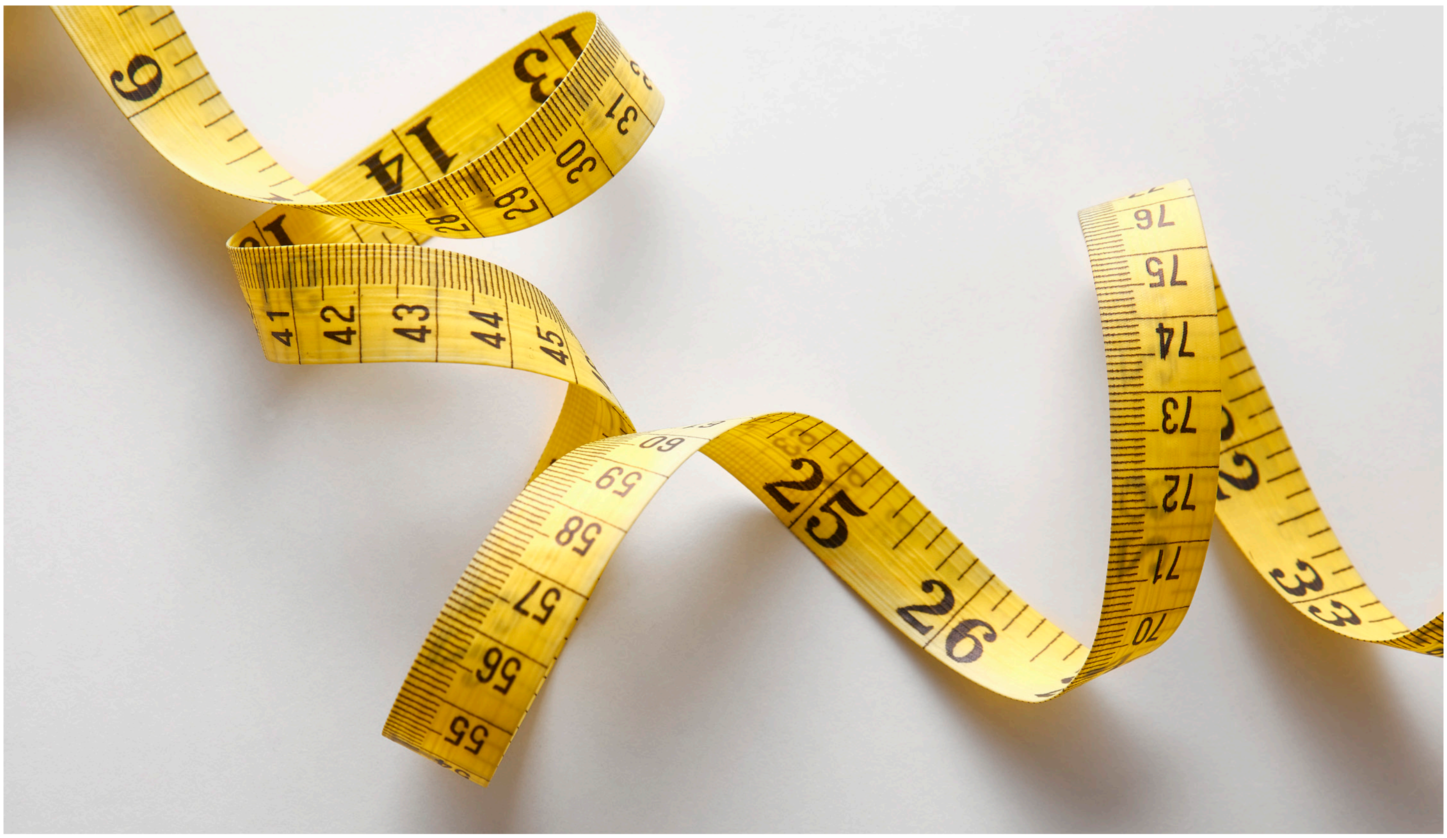
A Commonfund Roundtable

Governance Best Practices: How Does Your Board Measure Up?



Since our founding in 1971, a core element of the Commonfund mission has been to provide insights on a broad range of governance, policy and investment challenges. An engaged governing board is important in all environments — but perhaps no more so than today. Markets are at new highs, yet there remains much uncertainty — from the inevitable market correction to disruption of many nonprofit operating models to the impact of recently enacted tax law changes. As we start 2018, Commonfund Institute convened a panel of thought leaders to discuss current practices in nonprofit governance and offer ways for boards to bring best practices to their processes and deliberations. The discussion was moderated by **John S. Griswold**, *Founding Director of the Institute. The three panelists were:*

Thomas K. Hyatt, *partner in the Washington office of Dentons US LLP and co-chair of the firm's U.S. Nonprofit Entities Practice. He is a Senior Fellow for Public Policy at the Association of Governing Boards of Universities and Colleges (AGB) and was recognized as Outstanding Nonprofit Lawyer of the Year for 2017 by the American Bar Association.*

Robert B. Litterman, PhD, *Chair of the Risk Committee and a founding partner of Kepos Capital, a New York City-based systematic global macro investment firm. In a 23-year career with Goldman Sachs he headed the firm's risk management function and co-developed the Black-Litterman Global Asset Allocation Model, a mathematical model for portfolio allocation. He is Chair of the Board of Trustees of Commonfund, and serves on other boards, including the World Wildlife Fund and the Robert Wood Johnson Foundation.*

David Nygren, PhD, *founder of Nygren Consulting and previously founding Senior Partner of the Corporate Governance Consulting Group at Mercer Delta Consulting. Formerly, he was Executive Vice President of DePaul University and has held teaching and research appointments at Harvard, Yale and Boston University. He has served on or chaired the boards of numerous organizations in education, health care and the arts.*

John Griswold: To start, let me ask about the state of governance in the nonprofit sector today. Satisfactory? Improving? Lagging? Tom, start us off, please.

Tom Hyatt: I believe the state of governance in the nonprofit sector is improving significantly. I got involved in the nonprofit sector about 35 years ago when governance wasn't on anyone's radar screen. It was not uncommon for hospital governing boards or college and university boards to be quite large — people often served for decades and there was minimal turnover. Little thought was given to best practices.

Today, leading nonprofit associations have stimulated new thinking about best practices, performed empirical research and shared "war stories" everyone can learn from. There's more attention being paid to governance than ever before, a stronger desire to "get it right," and to understand what best practices are and how to implement them.

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David Nygren: I absolutely agree that governance is improving. At the same time, social media has heightened our awareness of public scandals, creating a sense of urgency and compelling trustees to be more fully aware of the risks they may be undertaking as board members. As the visibility of boards has increased, some are reconsidering whether they even want to be board members and expose themselves to potential risk. So, one, we have become more conscious of governance issues as the risk has intensified. Two, and more importantly, people engage in board work more conscientiously because they know that they are far more accountable and publicly responsible than they were in the past.

There is also a desire to include diverse members on our boards. There was a time when a male-only board might have been populated with one female; whereas the lack of diversity was never seen as problematic in the past, today we understand the value of diversity. We have come to view boards as less than fully effective if they are not diverse. So, across the whole spectrum we are elevating our understanding of good governance.

Griswold: David, you mention social media and transparency, and then there's ever-faster news cycles. Are they creating more of a challenge to boards in terms of responding to whatever crisis or issue is at hand?

Nygren: I think the "wow factor" coming out of recent scandals in Hollywood, Washington and elsewhere and the collapse of some of our iconic leaders has made all boards wake up and say, "Wow, there but for the grace of God go I." Board members weren't aware of the risks inherent in some policies and practices, or the secrecy that was embedded in certain procedures. You can start with corporate and church scandals 15 years ago and fast forward to today's media and political scandals and see that there's a lot of second-guessing when it comes to public accountability and transparency.

Griswold: Bob, you've been on several boards, including the Robert Wood Johnson Foundation, the World Wildlife Fund and, of course, Commonfund, where you're the Chair. Have you encountered difficulties that challenge the governance model you've been operating under?

Bob Litterman: No board is perfect, but I've experienced nothing that I would say represented a serious challenge or any kind of misconduct. Commonfund is an interesting board situation because while we are a nonprofit we also compete against for-profit institutions. So, you are operating both a business and a nonprofit. Each has a different set of priorities. How do you balance them? That's the issue for Commonfund's board. Commonfund needs to marry the mission of a nonprofit with the accountability and urgency of a business.

Griswold: Tom, you've been writing recently about fiduciary issues. Do some of the trends that we're talking about here challenge the traditional notion of fiduciary duty and responsibilities?

Hyatt: I'm not sure they challenge it as much as they place a greater emphasis on the need for boards to understand what it means to be a fiduciary. That includes how the fiduciary relationship is different from others, both legally and in terms of engagement with the institution. As well, it calls for understanding the difference between governance and management, and to understand not only what fiduciary responsibility is, but also where it stops.

At any given moment, the traditional duties that we talk about — the duty of care, the duty of loyalty and the duty of obedience — can become a critical matter for a board. If you've got a conflict of interest issue before the board, the duty of loyalty becomes huge. It does not necessarily have to represent a financial conflict. It may be a duality of interest. Those can be some of the most challenging cases to deal with, so understanding what your fiduciary responsibilities are to the organization, above and beyond your own private or personal interests, is tremendously important. The duty of obedience is making sure that you're compliant not only with your mission and purpose but also with the law. And, as I have often said, the duty of care is first and foremost the duty to engage, to prepare and read materials, to ask questions, to attend board meetings regularly and to be involved in them.

David Nygren, PhD, founder of Nygren Consulting and previously founding Senior Partner of the Corporate Governance Consulting Group at Mercer Delta Consulting

We talk about dysfunction and disruption on boards and, certainly, there is some of that. But I would say the greater challenge is apathy — a lack of engagement. Occasionally, that's a failure of the individual or a result of poor recruiting. But more often, it's a failure of board development and board leaders acting to get everyone involved, engaged and feeling like they have a role. That way, they want to attend, and they can lend their competencies, skills and voices to the discussion and not remain on the sideline.

Griswold: Let's talk about some of the specific practices we've observed over time. One is board and trustee assessment. What kind of approaches have we seen evolve in recent years?

Robert B. Litterman, PhD, Chair of the Risk Committee and a founding partner of Kepos Capital and Chair of the Board of Trustees of Commonfund

Nygren: Boards never used to think about assessment, and if they did it was very rudimentary — like sitting down and saying, "How are we doing this year?" That's evolved because of work by the New York Stock Exchange, NASDAQ, BoardSource, Commonfund and others, as well as institutional investors insisting that boards perform to the top of their capabilities. Now we are seeing assessment evolve into quite a specialized discipline. I've spent 30 years developing assessment processes and looking at behavioral indicators of effectiveness. I think that there are predictable dynamics within boards that deserve assessment, not only readiness and preparedness and the duty of care, but also the depth to which someone is able to contribute to the incredibly diverse financial and business portfolio of both nonprofits and for-profits.

I prefer an annual assessment of a board that is done either through open-ended conversation or a survey. I have also found that the most powerful form is peer assessment, where directors periodically review one another's performance. It might be at the end of a term or re-nomination for a second or third term. The point is we have to get to a place where we're telling the truth to our colleagues and have them know if they're adding value or not, even if at one point they did. Environments change so dramatically that we now need to think of new competencies.

Litterman: We just went through a trustee assessment at Commonfund, and I think it can be and is a very important governance standard. To put it in a slightly broader context, obviously you need a strong governance committee and governance process, and assessment is a very important part of that. But, that raises two issues that boards sometimes find difficult: One is the time involved to do it well and the other is whether you really want to make a strong statement about another person on the board. The most important thing is that you have an effective process for board renewal and that it is taken seriously.

Griswold: David, what do you consider the best practices in terms of dealing with an assessment process that ends up surfacing certain problems? What's the mechanism that makes it work?

Nygren: A lot of shareholder activists and investors insist on good governance, and they are challenging some very well-known companies about the mediocrity of their board. We looked at some of these corporations, and the investors are saying, "We're happy to invest, but we want a guarantee that our investment is overseen properly." So, first of all, shareholders are asking for greater oversight. Secondly, in terms of the nonprofit sector, the chair or the head of the governance committee has to ask, "Are we doing the very best that we can do? Let's not make this complicated, but let's just be grounded in facts and honesty. Are we really adding value here?" You'll get one answer if you're a strong and productive board. You'll get another answer if you're mediocre. The irony is that mediocre boards tend to think they're doing just fine, and outstanding boards are constantly trying to learn and are never satisfied.

The risk of self-evaluation can be that you are blinded by your own affiliation with the group or the tenure of these people. You like them all. You think everyone is doing a great job. But, the CEO may say, "You know, I'm just not getting the juice I need from this board to guide and govern and look to the future." So, there's a fine balance between durability and tenure and refreshing the board with new ideas and new competencies.

Hyatt: I agree. At the end of the day, assessment is about accountability. It's about ensuring that you're being held to a set of standards and acting on them. There's an input and an output aspect to that. The input aspect is, assessed against what? Do we have metrics by which we know we're doing a good job or not, and do directors understand that? That's really about board education. That's about board culture. It's about ensuring that a director understands what he or she is expected to do, whether it's as simple as coming to meetings or as complicated as providing leadership on particular issues. The output aspect is, what do we do with that? If we just do an assessment and have a pretty dashboard, it may look great, but it doesn't go far enough. You need to reflect on that, and to David's point, say, "Are we doing a great job? Are we inadequate in areas where we could be doing better? Is there a particular issue to be addressed, e.g., we're not meeting frequently enough or we're not diverse enough?"

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Griswold: Let's turn to culture. How does the chair or board establish a healthy, positive culture when so much of environment these days is "in your face," so to speak? In the past, everybody knew everybody else — you recruited friends and family to the board. Now, the sense of accountability and responsibility has increased enormously.

Hyatt: We have to be realists. We live in dissonant, disruptive times — not that that's all bad. Disruption can be a positive force, but it can easily devolve into a situation that leads to personal attacks where you don't respect others' points of view. It can lead not only to dysfunction, but also to disengagement, apathy or withdrawal, and all of those are significant governance problems. It seems to me that you can avoid them largely by creating a culture that promotes active involvement, accommodates different points of view and promotes mutual respect. The boards that I have enjoyed serving on the most have been characterized by what I call a caring culture. It's where we've done some board work, some team-building exercises, we've gone on retreat, we've gotten to know each other. When we do have difficult moments, where we might disagree on a particular issue, we nevertheless treat each other with affection, respect and care.

Litterman: I serve on a number of boards, and I feel that way about most of them. The board members feel like they're part of a family and treat each other with respect and care, even though they take their jobs very seriously. I think that kind of environment is the rule rather than the exception, but it doesn't happen by accident. It's the result of careful board member selection and a constant focus on mission. It's very different, I think, in the nonprofit space than the for-profit space. But in either case, board members can make difficult decisions while treating each other with respect.

Griswold: David, are there any methods that you've seen used to transform a board from a dysfunctional culture to a healthy culture?

Nygren: Yes. One to remember is the psychological principle that behavior is affected by its consequences. If there is no consequence of bad conduct or not showing up or not coming prepared, you're not going to see change. Culture is about establishing a routine, a best practice, an agreement, a social contract, whereby we agree to interact with the guidelines or the principles that my two colleagues have just identified. If you come up with a board compact or a set of guidelines by which you are operating, it's easier for the chair to say, "You know, you don't seem to abide by what we agreed to." You're able to have that conversation. But without a set of principles or guidelines for governance, it's very hard to confront someone and say, "You're not living up to the guidelines." Because the person may respond, "I never saw the guidelines. I didn't know we agreed to them." So, board education, board orientation, board development, board assessment — each of these is critically important.

We've all been on good boards, but there comes a time, whether the CEO tells us or we come to the agreement ourselves, that we must improve, find new skills, add new members or increase diversity. It may mean that some of us must retire or move on in order for new competencies to enter. That's where the chair comes in with an invitation to open the door to new members and new ideas. Staying fresh is critical to maintaining a strong culture.

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>
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Griswold: Where are boards when it comes to term limits? Are boards agreeing to some sort of term limits or perhaps an age cap, if that's appropriate?

Nygren: Generally, a best practice or recommended procedure is term and age limits. For a contrary view, however, I think sometimes we let our best talent out the door. Having worked very hard to train and prepare them, if we have a six-year limit and we're talking about our strongest contributor, the question is whether exceptions can be made to those term limit boundaries. I would say the only way in which term limit extensions should be considered is if rigorous assessment is being conducted. You've got two choices: Either you do rigorous assessment or you do term limits. Otherwise, it's very hard to refresh the board in a systematic, fair and non personal way.

Litterman: The issue with term limits, frankly, is that it can lead to laziness, i.e., we'll just wait until that person term limits off rather than making the more difficult decision to be proactive. Board assessment is the way to address that.

Hyatt: I agree with that. I'm a believer in term limits because I think they force the board to actively confront the challenges and goals that we've talked about. You can set those limits where you'd like. You can also employ a hiatus period, meaning that if someone is really good and has been well developed they can take a year off and be brought back again. I'm much less of a fan of age limits because it's so relative. One person's old age is another person's young age. I think term limits are a more effective rule there.

I also think it's helpful to pair term limits with another provision that I increasingly write into bylaws and it's one that we talked about earlier: the duty to show up. You can have a provision stating that if a director misses "X number" of consecutive meetings without good cause, he or she is deemed to have resigned from the board. The bar as to what constitutes good cause can be set as high or as low as the board likes, but it puts the onus on the person who isn't showing up to justify their absence.

Griswold: That leads to a question about succession. Is there a best practice emerging now in terms of succession for the chair?

Nygren: I don't think we're doing a great job in this area, but I would say that wise chairs are constantly grooming, identifying and, if necessary, recruiting their successor. I'd heard that long before I ever became a chair; once I did, I understood its wisdom because grooming the chair can take two to four years.

I could give you examples of some major organizations that have failed to find the right chair and the consequence has been the failure of the institution, either financially, reputationally or just in terms of governance. Another challenge is the difficulty of finding good chairs; some are called upon to serve in many places. Good chairs know when to say no. Few of us can handle serving as Chair of more than one board. Chairing two boards may be necessary as we bridge terms from one Chair to another.

Hyatt: I struggle with that also, even with the question of serving on more than one board at all, let alone as chair. To do the job well and stay focused, you have to marshal your talents and your time. But to the broader question, I think leadership development is an area where we have a lot of room for improvement. My experience has been that it's done ad hoc. Who selects the chair? The governance committee? The staff or CEO? Is it an organized process or a popularity contest?

It would be better if it were more systematic — bringing in good people and then grooming them for leadership posts. You also want to give them the experiences they'll need to be a good board chair. So, for example, if you think someone is going to be a chair, some time on the finance and audit committee is helpful in understanding finances at an in-depth level. Perhaps a vice chair of the board — who may not have much to do in that office — can chair the governance committee and automatically get involved in some of the critical governance issues that affect the board before they take on the larger job of chair. If you do that,

Thomas K. Hyatt, partner in the Washington office of Dentons US LLP and co-chair of the firm's U.S. Nonprofit Entities Practice

you've got some really good choices when it comes time to choose a new chair.

Litterman: The idea of thinking about structure and who's going to take on the leadership role is critically important — central, really, to the governance process. Certainly, it can't be left until that time when a new chair is needed, so it should be on the top of the board's mind long before the actual succession.

Griswold: What about recruitment and orientation? For instance, what about recruiting the younger generation, most of whom have had quite different experiences than earlier generations?

Nygren: I think it's very tough. I trained 600 African-American and Hispanic candidates for health care system boards for the American Hospital Association. It was an amazing pool of talent across nine cities. Yet, it was very difficult to place them, not because they were not amazingly talented, but because the network, the institutions, do not think about those that they do not know or associate with when they're seeking to place people on boards. It was very

John S. Griswold, Founding Director of the Commonfund Institute

hard to weave them into the cycle of recruitment. Half of the 600 I would have put on a board tomorrow, practically speaking. But it's really hard to network them into the processes that are already in place.

I think the talent is out there, but our processes as yet have not caught up with the available talent of millennials and others. I think recruitment is the front end of this challenge. I often get into conversations with corporations that ask whether they ought to use a recruiter. The recruiting discipline that search firms use for director searches has proven to be helpful in some instances, but not all.

Hyatt: I would simply add that recruitment and development are a 365-day-a-year job. You can't just simply wake up and say, "The annual meeting is next month. I guess we better go out and find a few folks." It has to be the job of the CEO, the board chair and the governance committee throughout the year. And what a dream it is to have that pool of people, young ones in particular, that David just described, to choose from. But, many times, boards don't know how to make that connection . . . they don't know how to best reach out and find those people. To that end, I think that's a real change in governance thinking of late — getting away from a representational model into more of a competency- and skill-based model. If there's one thing that demographers have told us about millennials that's a bit different, it's that they're not instinctively joiners. It may take more meeting time, more getting to know each other time, to get younger directors comfortable with their governance roles.

Nygren: The normative expectation for millennials is that we relate to them through social media. That's becoming standard. They expect our boards or our CEOs to be able to relate to them through social media, and we're not particularly well equipped to do that yet.

Griswold: Another question I want to get into revolves around socially responsible investing, or SRI. It also takes the form of ESG (environmental/social/governance) investing or impact investing. In your experience, how do you see a board being able to deal with an issue that can be contentious when you've got some people on the board who are really pushing the idea and the rest of the board is skeptical if not resistant? How does that play out?

Litterman: I think that every board is different, and there are going to be different investment solutions for different boards. At Commonfund, we've been working with clients for years now and each has its own approach. For example, at the Robert Wood Johnson Foundation we have prohibitions against alcohol, tobacco and firearms. That's something that the trustees there just felt was antithetical to their mission long before I got there.

Today, we are seeing the issue of divestment with respect to fossil fuels; this is coming up for discussion more frequently, and it's not the same answer at every board. Some boards have very much focused on the governance associated with their ownership of fossil fuel companies. At the World Wildlife Fund, we had a long discussion of what we should do with fossil fuel companies, and we came up with an innovative solution where we actually entered into an overlay that hedged the stranded asset risk in the portfolio. There are lots of ways to have the discussion, and it's not one size fits all.

Hyatt: To Bob's point, whenever you've got responsible investing and corporate social responsibility in the mix, as a board you've always got to come back to your touch points of mission, purpose and strategic plan. It's easy to bring your own set of biases and goals to the table, and they may or may not be entirely consistent with those of the organization. But, coming back to your mission, purpose and strategic plan will help ensure consistency. Answers are easier when they are consistent with those three touch points.

Nygren: I couldn't agree more with what Tom said. The question is grounded in mission and purpose and, for for-profit organizations, shareholder interests. But underlying most strategic decisions is a moral question or an ethical/impact question. The collective conscience of the board has to wrestle with consequences of any vote or action taken. It might be a financial impact, for instance. Socially responsible investing can have a downside for investors, but it may be for a good reason or an ethical, sustainable purpose. Good leaders and good board chairs raise moral questions and don't fear or run from them. I also agree that bias can influence mistaken preferences, and so we have to be vigilant and not be afraid to engage in those questions that may have a moral or ethical consequence.

Griswold: In closing, let me ask you about the future. Do you see anything ahead that may be a game-changer or is simply growing in importance and potentially spawning a new trend in governance?

Litterman: When we were talking about recruiting new board members, I would just underline the observation that this is a full-time job for the board. It's not just something that you do before an annual meeting. Most of the boards that I am on have formalized this process in one way or another. At the World Wildlife Fund, we have a national council, and we often think about members of the national council as being potential board members. I term-limited off the board at World Wildlife, went on to the national council for a year and I'm now back on the board. That worked well.

At some of the boards I'm on, we invite outsiders to sit on the investment committee as advisors, giving us the opportunity to think about them as potential board members. I think any way that you can engage over a length of time with potential board members is very helpful.

Nygren: I find myself shocked by the polarities in our society today regarding the role of institutions and how public policy is shaping the common good or lack thereof. So, I think trustees and directors have an opportunity to shape the common good, and by having these difficult conversations regarding the polarities of view that seem to exist for whatever reason — political or religious, educational, class, whatever the variation might be that causes polarity — it is in the interest of our society to bring our institutions together to have meaningful conversations.

I don't want our institutions and trustees to be politicized. We should be focusing on the common good, whether it's for shareholders or our communities. We have an opportunity to say, "Are we thoughtfully guiding our direction toward what is best for our world, and thereby harmonizing some of the polarities that we see?" I see this as a very meaningful role for trustees and directors in shaping the common good.

Griswold: Tom, what's your view on the tax reform act that has just been enacted? Do you see it fundamentally changing the landscape in nonprofit board work?

Hyatt: I don't think the tax reform bill, as we've seen it thus far, is going to change much from a governance perspective. Happily, some of the things that would have done that were left on the cutting room floor. Some of the changes are certainly going to affect nonprofit operations and expense, but not so much on the governance side.

But, as I think about this conversation and these particular issues, the two parts of the nonprofit sector where I've spent most of my time, health care and higher education, come to mind. And one of the developments that we see across the sector is the increase in consolidation among institutions. If you are a small, single-sex, rural liberal arts school, or if you are a small, urban faith-based school, right now there's a very good chance you're in financial distress. If you are a standalone community hospital — one of the few that are still out there — the odds are very good that you're having conversations with someone about affiliating with their system or doing an asset transfer and simply getting out of the game. These are times that produce great stress and conflict for these institutional boards.

So, it is essential right now as we promote board education and development, to prepare boards to do that difficult work. Unfortunately, boards can do everything right and still end up in a difficult spot. I can think of specific instances where boards arguably fulfilled their fiduciary duties to the maximum, did the right thing and made solid, legitimate, good governance decisions. Nevertheless, they found themselves out of a job because of a different constituency or a politician saw it another way. Board members need to be prepared for that potential outcome.

Griswold: Let me thank each of you very much for your thoughtful, insightful comments. There's a lot of wise counsel in what you have to say, and we believe trustees and directors stand to benefit from it.

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Market Commentary

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