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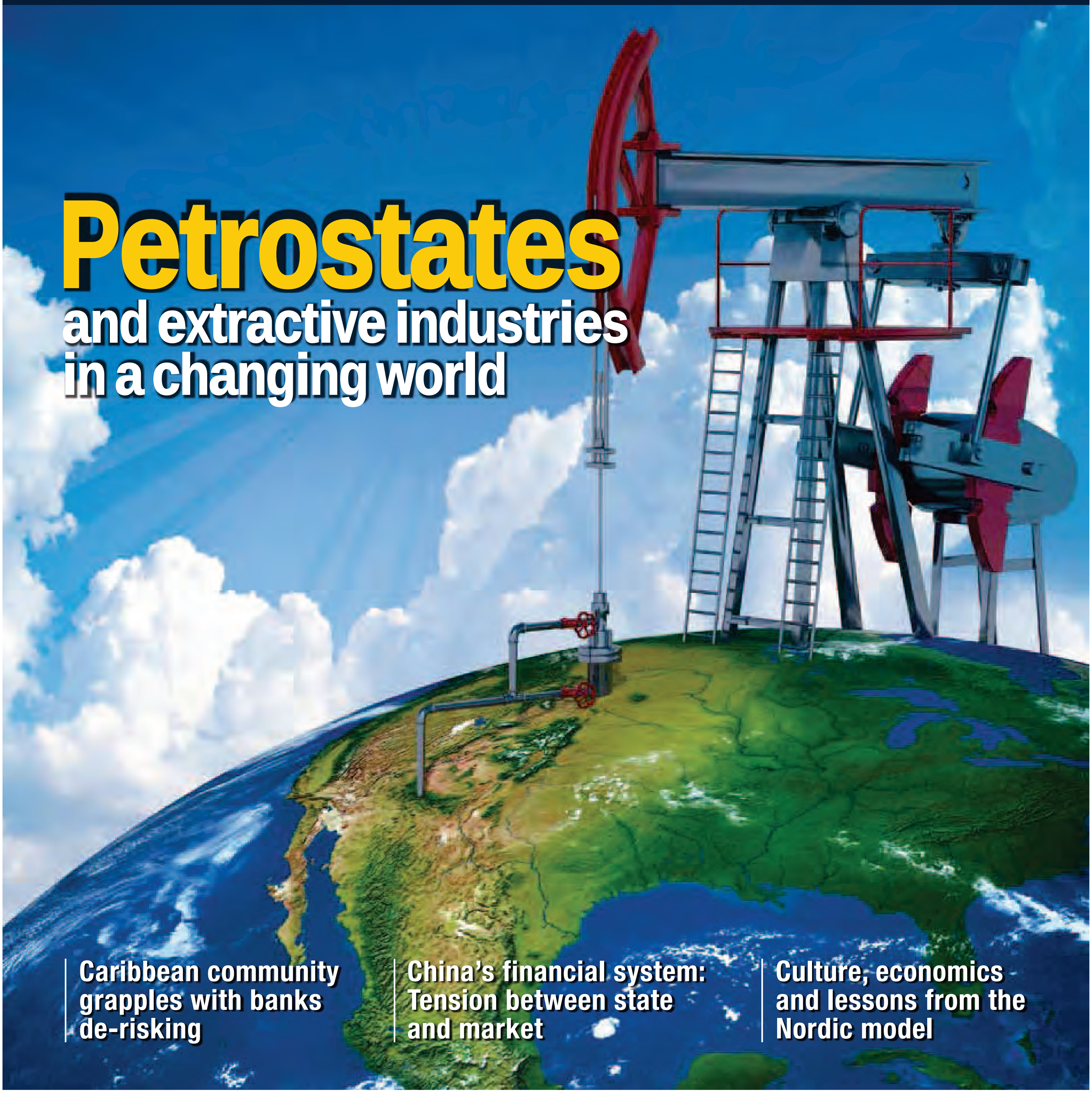

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Independent directors and the split board saga

Geoff Ruddick, an independent fund director and head of funds for International Management Services, sheds some light on the topical subject of "Split Boards" – engaging independent directors from different fiduciary firms.

There has been an extraordinary focus on and trend towards "split boards" in the last few years. For most people the accepted definition of a "split board" is having independent directors from different fiduciary firms. It is considered by some to be the best way to construct a board. In reality this is an overly simplistic definition and assessment of how to recruit and construct an effective and diverse board. So how did this readily accepted definition come to be? In some respects there is merit and in other respects it is simply a sales pitch.

Governance is not a game. Unfortunately, in the past few years fundamental governance related issues such as board composition (split boards), capacity (numbers) and substance over form, (form over substance) have been used as marketing pitches. These are fundamental governance issues yet the sales side of the issue is increasingly the focus of attention. Just as numbers were once perceived to be the key component in assessing a director's "capacity" the industry has now come to understand that numbers are only one factor. Similarly, the concept of "split boards," whereby engaging independent directors from different fiduciary firms, is often a material consideration and sometimes the key focus in assessing board composition. This narrow focus, for the most part, misses the fundamental objective of establishing an effective and diverse board.

The directors are individually and collectively responsible for leading and directing the fund's affairs. Effective corporate governance is imperative, and recent issues, scenarios and outright collapses highlight this point. As regulators and investors continuously increase their focus on corporate governance, the requirement for the appointment of independent directors is essential. Investors in particular have recently become increasingly interested in board composition and appointing directors with complementary skill sets.

There is currently a trend to recruit some combination of an accountant, lawyer, ex-regulator, investment or risk expert from different shops to attain complementary skill sets. In response, there has been an influx of individuals into the industry whereby self-promotion of these skill sets, to make up an effective board composition, has become the latest marketing pitch. One important skill set that is often overlooked is corporate governance in itself. Possessing one of the aforementioned technical attributes in isolation does not necessarily make someone a good director. Perhaps even more important than having a director with a specific skill set, expertise, or being from a different fiduciary firm is to select directors who have a broad range of experience, have the innate ability to ask intelligent and probing questions, and know when and where to find expert advice when needed. It is often more effective to engage someone with specialised expertise when needed rather than recruit it onto the board. Ultimately, the aim is to have a board composition that is sufficiently diverse to have the necessary knowledge to provide effective leadership and direction.There is certainly a greater depth of high quality directors in the space to choose from than there was a few years ago. The flood of new entrants into the fiduciary space can be partially attributed to a supply shortage as long-standing individuals are reaching capacity. Some newcomers are simply being opportunistic as they are looking for a career transition. Most are senior people who have excellent experience, qualifications, pedigree etc., and are able to seamlessly make the transition from being an administrator, lawyer, auditor, regulator, risk or investment professional etc., to being a director. Others, however, have difficulty making the transition, as although they have impressive technical skills, they are unable to transition into a leadership and oversight role that goes beyond their area of expertise. Individual personalities can come into play as well. For example, some are too passive, lack the intellectual curiosity, or gravitas to effectively and appropriately challenge management or their fellow directors, while others have domineering and controlling personalities or simply lack the aptitude to participate in a collective approach.

As it is for many things in life, the right balance of individualism and collectivity is also paramount to an effectively functioning board. Additionally, the ability to put issues into the appropriate context is imperative - sometimes the board has to provide high level oversight and other times a more detailed approach is required, but without becoming a micro-manager. Effective and experienced directors will be able to maintain perspective and context in such situations, regardless of their specific skill set.

The focus in constructing an effective and diverse board must go beyond just looking at attaining a "split board" and consider each potential director's attributes as mentioned above. It is disingenuous to suggest that real independence and diversity cannot be obtained via having multiple directors from the same provider. This really depends on how each fiduciary provider is structured, in combination with the individual's own attributes, and perhaps more importantly how they perceive their role and conduct themselves

as an independent director. With that said, there is an argument that retaining individuals from different providers eliminates the risk of potential "groupthink." If this is indeed the case it is good reason for a change. Do keep in mind though, that groupthink or deferring to a more dominant director still happens in "split board" scenarios as well. Therefore, "split boards" may be more perception than reality, as many fiduciary firms have engaged professionals, with complementary skill sets, and have the freedom to make independent decisions. As such, there may already be an effective board in place.

Serving as a director is a personal appointment and there is corresponding personal liability. In today's post-Weavering environment passive directors are, for the most part, a thing of the past regardless of whether they serve alongside a colleague or someone from a different fiduciary firm. An effective and diverse board requires competent individuals with complementary skill sets who can work collectively irrespective of whether they come from the same shop or not. The collaborative aspect is equally as important as the individual expertise. There should ultimately be synergies gained so that the board's collective value equates to more than the sum of its individual members.

So how do you go about selecting an individual and building an ideal board? As mentioned earlier, independent directors come with varying backgrounds, experience, qualifications, styles, interpersonal skills and corporate support - check around to compare and contrast. Investors, legal counsel, administrators, auditors and other professional service providers are a good starting point and will have a shortlist of individuals with whom they are familiar and would recommend. Once recommendations have been received make some additional enquiries to find the individuals who are right for the fund. Some suggestions for consideration follow.

Independence - the "Holy Grail" of effective corporate governance. If a director, or the organisation for which he or she works, is not independent, conflicts of interest will inevitably arise and could interfere with the director's ability to act in the best interests of the fund.

Experience - a director's bio should provide a detailed summary. In addition, ask specifically if they have served on boards with similar strategies. Independent directors do not need to be experts; however, a general understanding of the fundamentals of the underlying strategy is essential.

Qualifications - a legal, accounting, compliance, investment, risk, corporate governance or other relevant qualification, combined with experience, will provide a good indication of where their specific expertise lies and how they will add value.

Support Infrastructure – although most consideration should be given to the capabilities of the prospective director, there may be times when the individual may not be available. People take vacations, encounter emergencies, come and go from an organisation or jurisdiction, and start-up businesses often fail. Confirm that the individual has a sufficient support infrastructure to cover these contingencies, and whether they have colleagues who can be appointed in their place should the need arise.

Capacity – it's a function of time and ability, not simply numbers. The number of directorships will provide some insight, but it is only one of the many important questions to ask as numbers in isolation can be misleading. Drill down and look at the composition of the clients the director serves; their role within their company; what other responsibilities they have beyond serving in a personal capacity on fund boards; their company's model, support infrastructure, back-up and coverage; and their capacity constraints. Other matters for consideration include whether the director has excess capacity for times of stress; and perhaps most importantly determining how they personally view their role as a fiduciary.

References - any thorough "interview" will end with the question of references and therefore it would be prudent to receive some positive feedback from clients who utilise the candidate's services or other directors who serve on a board with the individual.

Conclusion

Looking for an independent director and constructing an effective and diverse board does not have to be an arduous, time-consuming process, however, the decision should not be taken lightly. Remember, the directors are accountable for leading and directing the fund's affairs. Effective corporate governance is critical and therefore the appointment of experienced and qualified independent directors who collectively provide a diverse and complementary board composition is essential. The influx of individuals with varying skill sets into the fiduciary space is a positive development, however, the industry needs to ensure the focus remains on the underlying fundamentals of good governance. So go beyond the "split board" sales pitch – have a thoughtful, measured approach and give all aspects due consideration.

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