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Could Your Board Fall Into Any Of These Traps?

If you are considering making changes to your board, before you take any action ask yourself these questions: What is the most important contribution our board can make? What, if any, changes need to be made to ensure that they achieve the desired results? Then, carefully review the following list of pitfalls to make sure that you don't inadvertently fall into them while attempting to improve your corporate governance.

1 Imbalance Between Insiders And Outsiders

A recent best-practices panel, hosted by Director's Alert and entitled "Boardrooms in a Post-Enron World," stressed the importance of recruiting and maintaining a "strong, independent board." An independent board means no family members, former employees, or paid advisers to the company. Best practice, according to the panel, calls for a substantial majority of independent directors. In addition, key committees such as audit, compensation, and governance ideally consist only of independent directors, and committee assignments should be made by the board itself rather than the CEO. In fact, the Sarbanes-Oxley Act, which was signed into law by President Bush last July, mandates that boards have audit committees drawn from independent directors.

But, to this general advice we'd like to add a word of warning, which is often forgotten as companies scramble to jump on the bandwagon of board reform. Having a majority of outside directors does not, in and of itself, guarantee good governance: Enron's

14-member board included only two company executives, and its key committees had none!

In fact, the recent call to eliminate insiders from boards may constitute a dangerous trend. While it is important not to "stack" the board with friends of the CEO, it is equally important to include people who possess first-hand knowledge of the organization. Including objective insiders from key functions—either as permanent or *ad hoc* board members—is not necessarily a bad thing. After all, they are a vital information source, possessing details about their respective functions that the CEO cannot be expected to have at his or her fingertips.

In short, there needs to be a balance between insiders and outsiders on every board. How many of each should be included? Only your organization can make that call.

2 Lack Of Functional Diversity

New SEC standards for audit committee membership have resulted in a rush to recruit board members from the financial function. This new emphasis, along with the widespread

belief that filling board vacancies with “legal eagles” will nip wrongdoing in the bud, has the potential to create highly unbalanced boards.

A board needs to be functionally diverse: representatives from the financial and legal functions are critical members of every board, but they need to be augmented by representatives from other key areas.

To ensure that your board is well rounded, we suggest you conduct a gap analysis of directors’ skills. Ask yourself which, if any, of your current board members excel at the following:

- strategy
- organization design/restructuring
- change management
- technology
- finance
- marketing
- human resources
- government/regulatory issues
- global experience
- other critical areas of expertise that are needed for your organization’s success

If your board’s expertise is incomplete, or if there is redundancy among your directors, you should begin planning to augment or replace them as soon as possible.

3 Failing To Recruit Strong Directors; Not Replacing Weak Ones

Another best practice recommended in “Boardrooms in a Post-Enron World” deals with strength. Keeping a board strong or replacing its weak links is vital, according to the panel.

Although directorships shouldn’t be life appointments, in some companies board members have been permanent fixtures for decades. On the best boards, nominating directors for reelection is more than a rubber-stamp review. Conducting a regular evaluation process is critical to maintaining the strength of your board. One suggestion: charge the nominat-

ing committee with developing a list of directors that it would like to have and comparing it with the existing board; sitting directors who don’t measure up could then be asked to step down. A more revolutionary idea, but one that certainly has its merits, is requiring the nominating committee to certify to investors its reasons for re-slating directors, in the same way that the compensation committee must explain its CEO-compensation decisions.

Term limits have been set for many elected positions, including the Presidency, so why not apply them to directorships? And, by all means, set a mandatory retirement age and stick to it.

4 Focusing On Sitting CEOs

Unfortunately, many companies still subscribe to the popular wisdom that sitting CEOs make the most effective directors. Certainly, these individuals bring valuable experience and insight into the boardroom, especially if they come from within your industry. If they run a well-known, well-respected company, they also bring prestige. But, there are many reasons why sitting CEOs are not necessarily the best choice for directors.

Many CEOs serve on numerous boards. They lend their name, but have neither the time nor the inclination to roll up their sleeves and produce results. They end up being mere figure-heads, which few companies can afford in times of close scrutiny by government and investors.

The National Association of Corporate Directors recently reported that a board member typically puts in 150 to 200 hours a year. This includes preparation time, meetings, travel and conference calls. Most boards meet six times annually—and Fortune 500 companies average eight meetings per

year. And, according to the NACD, a dozen in-person meetings is increasingly the norm, while in larger companies holding more than 50 meetings and conference calls a year is not unheard of—a difficult time commitment for an active executive.

If you are still determined to recruit a sitting CEO as a director, it may not be as easy as you think. Many companies are now limiting the number of boards on which they will allow their CEO to serve; many are concerned about the potential fallout should their CEO become involved in a corporate scandal while serving as an outside director.

At the same time, many more companies are looking to fill board slots: in April 2002, one major recruiting firm reported that the number of board searches it had conducted rose 30 percent over the previous year. As demand for CEOs exceeds supply, it’s time to seriously consider the alternatives: retired executives, global talents, technology leaders, and younger and more diverse candidates.

5 Failing To Include Both Short And Long-Term Thinkers

An effective board is keenly aware of stock prices and quarterly results. Its members must be aware of short-term targets and how well they are being met. Only by staying on top of this aspect of the business can they catch deviations at an early stage and take quick corrective action.

But, boards also need to include proven strategic thinkers. A board should always have in mind the company’s strategic vision. If the members haven’t been involved in formulating the company strategy, they should have an in-depth understanding of it, and it should serve as their guide—their “Bible”—as they confer and make decisions.

The mistaken assumption that every company leader is a top-notch strategist is one of the reasons that CEOs have traditionally

been sought after as directors. In reality, strategic thinkers in the league of Bill Gates, Sam Walton, or Jack Welch are few and far between—and are not necessarily found at the top—as evidenced by the number of CEOs whose failure to formulate and adhere to a sound strategy has brought their company to ruin.

If you can’t target strategic thinkers by position, how can you identify them? Individuals who are able to make the mental leap from operational to strategic thinking share certain characteristics. They realize that no business operates in a vacuum; they are keenly aware of and understand the implications attached to political, social, and economic trends. They often take a global view while those around them are limited by domestic considerations. They are relentless questioners, always challenging the *status quo*. They think “out of the box,” coming up with creative solutions to long-standing problems.

Just as every board needs one or two financial experts, it also needs one or two strategic thinkers. These individuals may be members of the senior-management team, they may be industry experts, or they may come from a completely different environment: an unrelated industry, a non-profit organization, government, or academia. What matters is not where they come from, but how they view the world around them.

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At Day & Associates, we are committed to helping companies structure and recruit boards whose characteristics, commitment, values, and skills most successfully match their unique needs. We would welcome the opportunity to help you build your ideal board.