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Board effectiveness Niamh Brennan

In judging a board's effectiveness, one must consider its power to exercise control, monitoring and oversight roles.

Corporate governance is a complex system of moving parts, with boards of directors as the central governance mechanism. Corporate boards are assumed to have full power to exercise three key accountability roles – control, monitoring and oversight roles. However, these taken-for-granted assumptions may not apply to all boards.

Boards' power limits may constrain their assumed ability to exercise control, monitoring and oversight roles. Understanding the limitations of the boards of directors' role has implications for other governance mechanisms in that complex system.

Assuming boards can exercise control is, in many cases, a myth. It is important to understand board power limits in practice, otherwise there is a risk of an expectations gap on the part of investors and regulators between what boards are expected to do versus what they are capable of doing. Such an expectations gap can, for example, lead to investors not exercising their governance roles because they assume others are doing it for them; and to regulations that assume governance roles incapable of execution in practice.

Dr Margaret Cullen and I have studied investment fund boards, an extreme board type. We find that directors of investment fund boards cannot exercise control roles, or even monitoring roles. Their role is merely one of oversight. The explanation for this finding is that, because of its dominant power position, the fund promotor exercises the control and monitoring roles. We believe our findings extend to boards of directors of other organisational types or contexts such as subsidiary boards, boards of state-owned entities and organisations with powerful founder shareholder-directors. In such contexts, boards operate under a constraint, often arising from the power dynamics around the board or from shareholder power dynamics (e.g. parent-subsidiary relationships, government-state-owned entity relationships).

These insights led us to differentiate the three terms – control, monitoring and oversight – to understand the distinction between these roles. Dr Cullen and I distinguish monitoring and control by virtue of the level at which each is applied. We consider monitoring to involve direct review/observation of management performance, *inter alia*, through ongoing performance management assessments. Monitoring may be accompanied by consequences for employees who do not perform adequately – in other words, the exercise of control. Monitoring must precede control, but monitoring may occur on its own without subsequent control actions. If there are consequences following monitoring, they can be so minor as to not amount to control.

We characterise oversight as "keeping a watchful eye", acting on behalf of investment fund shareholders' interests in our study. Oversight is indirect. Those exercising oversight cannot take direct action, they can only obtain consequences through another party. Oversight is not an extra layer of control. It is an extra layer of indirect monitoring. The word "oversight" is frequently used to describe the work of audit committees. They are an extra pair of eyes and ears for corporate boards. Our distinction between direct monitoring and indirect oversight depends on the degree of observability. Direct monitoring implies a degree of proximity to those being monitored, an ability of principals to monitor agents themselves and an ability to establish and implement direct performance management processes. For example, traditional boards receive presentations from the CEO and senior managers and can thus directly monitor, face-to-face, their performance. This is not possible in investment fund boards as investment funds have no direct employees. Indirect oversight, in contrast, implies overseeing the mechanism or construct without the powers of direct observation, arising from observability at a distance and lack of proximity or the ability to take direct action.

We must also acknowledge the role of shareholder activism. Shareholders indirectly observe management and may take direct action as a result. For example, shareholders may vote against a resolution (e.g. CEO pay in a say-on-pay resolution) at an annual general meeting. For each of the three terms – monitoring, control and oversight – there is a continuum of behaviours from highly proactive directors to "spectator" directors, depending on effort levels expended by directors in executing their roles.

To conclude, in judging the effectiveness of boards of directors, their power to exercise control, monitoring and oversight roles has to be considered. Not all boards can exercise the three roles.

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