



Global
Corporate
Governance
Forum

Private Sector Opinion

BOARD PERFORMANCE EVALUATION

Issue 9

A Global Corporate
Governance Forum
Publication

Foreword

Boards are very complex social structures with enormously difficult jobs to perform. And being an effective director is getting tougher and tougher. The pace of change in today's world makes every business global in its own way and less secure in every way. How does a board get up the learning curve to a point where it can act as a value added contributor to the ongoing success of an enterprise?

Simon Osborne examines one of the most valuable tools available to today's boards of directors—evaluation. This comprehensive examination of the various processes to implement an evaluation and the most insightful questions to include in an evaluation should go a long way to helping any board improve its own performance.

From my experience of over 30 boards in four countries, a commitment to annual evaluations is a powerful change agent. Matthew Barrett, the recently retired CEO of Barclay's Bank, brought modern corporate governance to his previous position as chairman & CEO of the Bank of Montreal in the early 1990s. Board evaluation was then a very rare practice anywhere in the world.

The first evaluation of the board, its committees and of each director took place in 1994 and had an immediate and positive impact behaviorally. It is my recollection that we turned more in to a coordinated team rather than a random collection of A-type personalities. Directors listened better. There seemed to me to be more reflective consideration of the speaker's points than a desire to jump in with "your point" as soon as there was an opening.

In the subsequent years, the benefits have endured but the form by which the annual evaluations take place have been changed in order to keep a "freshness" to the entire process.

Simon Osborne's intelligent and comprehensive analysis of board evaluations is a sound platform on which to design, adapt and consider current evaluatory practices at your board.

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BOARD PERFORMANCE EVALUATION

By Simon Osborne FCIS, Solicitor
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This article originally appeared in the Institute of Chartered Secretaries and Administrators (ICSA) Board Evaluation publication in May 2008.

Introduction

Until the revised Combined Code on Corporate Governance came into operation for reporting years beginning on or after 1st November 2003, few UK companies were carrying out any form of assessment or evaluation of the performance of their board, despite an endorsement of the concept (falling short of a recommendation) in the 1998 Hampel Report (para. 3.13):

“A recent report of the US National Association of Corporate Directors recommended the introduction of formal procedures by which boards would assess both their own collective performance and that of individual directors. Some UK boards already operate such procedures. We believe that this is an interesting development which boards might usefully consider in the interest of continuous development, though we do not feel able at this stage to make a firm recommendation on the subject.”

The Review of the role and effectiveness of non-executive directors carried out under the chairmanship of Sir Derek Higgs in 2003 (the Higgs Review) noted that it is ‘best practice that the performance of the board as a whole, of its committees and of its members, is evaluated at least once a year’ and that ‘Companies should disclose in their annual report whether such performance evaluation is taking place.’

Most forward looking companies will have formal procedures in place for the regular appraisal or evaluation of both staff and departments at various levels throughout the organisation. Until comparatively recently, however, few had extended this process to the board itself which, given that the directors control major resources, both financial and human, and have responsibility for highly complex organisations, might be considered somewhat surprising.

The advent of the provisions in the Combined Code in July 2003¹, however, has meant that quoted UK companies have had to overcome the natural concerns of many directors and carry out an evaluation—not only of the operation of the whole board, but also of the three principal committees (audit, nomination and remuneration) and of the

¹ See now The Combined Code on Corporate Governance June 2006, Principle A.6

individual directors (both executive and non-executive). Boards seem to have come to terms with the requirement. Reporting on meetings held in May and June 2006 with chairmen of FTSE 100 companies, the Financial Reporting Council (FRC) stated that:

“The Code’s emphasis on evaluation of Board, Committee, and individual performance attracted universal support. Views differed on the frequency, scope and method of evaluation...What was clear...is that formal evaluation is seen as a valuable tool for improvement.”

Reporting on similar meetings with chairmen of FTSE 250 and Small Cap companies held in September and October 2006, the FRC stated that:

“With a couple of exceptions, participants had found board evaluation to be a beneficial exercise, although some questioned whether it was necessary to carry out a formal evaluation every year. There was no consensus as to the most effective method of evaluation; some participants had used external facilitators, while others had carried out the evaluation internally using a mixture of off-the-shelf and bespoke resources and processes.”

Most recently, in his valediction for the late Sir Derek Higgs reported in *The Financial Times* for 30th April 2008, the chairman of the FRC, Sir Christopher Hogg, said:

“The Combined Code as it now stands owes more than a little to Sir Derek Higgs and particularly the principle of board evaluation which has been found to be very effective.”

This guidance is produced to assist companies in understanding, and consequently managing, some of the major issues involved when considering how to carry out board performance evaluation. Different issues will apply to different companies, thus this guidance should not be considered as exhaustive. Hopefully it will trigger the thought processes so that boards may consider for themselves the issues that are appropriate to their own and their company’s circumstances.

In leading up to these decisions it can be useful to take a step back and try to identify the requirements of a board and the elements which need to be in place in order to achieve the optimum performance.

Requirements of a board

A board needs to make timely strategic decisions, to ensure operations are in line with strategy; to ensure the integrity of financial information and the robustness of financial and other controls; to oversee the management of risk and review the effectiveness of risk management processes; and to ensure that the right people are in place

and coming through. Non-executive directors are expected to provide an effective monitoring role and to provide help and advice as a sounding board for the executive directors. All this is in the long term interest of the company and should be based on the optimum level of information, through smooth processes, by people with the right skills mix and in a constructive manner.

Performance evaluation of the board

Board evaluation tends to break down into two basic areas; people factors and process factors. People factors tend to be by far the more important of the two in achieving an effective board—for example, how do the directors work as a team; what are their interpersonal skills; is there a dominant or bullying chairman or CEO; how effective is the senior independent director (“SID”); is the chairman an effective leader; do all directors contribute; what is the level of commitment (preparedness, engagement, absenteeism); is the board objective in acting on behalf of the company; is it robust in taking and sticking to difficult decisions; are decisions reached by the whole board; do decisions take account of shareholders' views; are there any “unmanaged” conflicts of interest; is the composition of the board being refreshed (succession planning)? Not all directors have a clear understanding of their role, duties and responsibilities. In some companies the executive directors, other than the CEO, do not really act as full directors but more as department heads looking to the CEO to take the lead.

The following are some of the more specific issues and questions that should be considered in a performance evaluation:

- Has the board set itself clear performance objectives and how well has it performed against them?
- What has been the whole board's contribution to the testing and development of strategy?
- What has been the board's contribution to ensuring robust and effective risk management?
- Is the composition of the board and its committees appropriate with the right mix of knowledge and skills sufficient to maximise performance in the light of future strategy?
- Are inside and outside board relationships working effectively? There may, for example, be problems getting the optimum level of interaction between non-executive and executive directors. Lack of contact between meetings and sometimes a lack of understanding of the role of non-executives (particularly in smaller companies) are both contributors to this. Occasionally, where a small caucus of key directors gets on particularly well, the non-executive directors can feel cut out—this requires particular attention to be paid to the provision of appropriate and timely information.

- How has the board responded to any problems or crises that have emerged and could or should they have been foreseen?
- Are the matters reserved for the board the right ones?
- What is the relationship between the board and its main committees and between the committees themselves?
- How well does the board communicate with the management team, company employees and others? How effectively does it use mechanisms such as the AGM, the business review and the annual report?
- Is the board as a whole up to date with latest developments in the regulatory environment and the market?

The processes that help underpin the board's effectiveness should also be evaluated, for example:

- Is appropriate, timely and unbiased information, of the right length and quality, provided to the board and is management responsive to requests for clarification or amplification? Does the board provide helpful feedback to management on its requirements? Many companies struggle, or have struggled, with getting the right level of information to the board. The optimum amount will vary from board to board depending on the type of business and the level of trust that has built up. Too much can be just as damaging as too little.
- Are sufficient board and committee meetings, of appropriate length, being held to enable proper consideration of issues? Is time used effectively? Getting the optimum number of board and committee meetings can be a problem—balancing the needs of the business with the time available from the best directors, particularly when there are overseas directors.
- Are board procedures conducive to effective performance and flexible enough to deal with all eventualities?

The role of the chairman is critical in any company and there are some specific issues relating to the chairman which should be included as part of an evaluation of the board's performance, for example:

- Is the chairman demonstrating effective leadership of the board?
- Are relationships and communications with shareholders well managed?
- Are relationships and communications within the board constructive?
- Are the processes for setting the agenda working? Do they enable board members to raise issues and concerns?
- Are all directors allowed or encouraged to participate fully in board discussions?
- Is the company secretary being used appropriately and to maximum value?

Performance evaluation of the non-executive director

A lack of interaction between the non-executive directors and the senior managers outside the board room can make it difficult for the non-executives to get a real feel for the business. This may be more of a problem where there is a culture against allowing senior management or external advisers to attend board meetings to present items. If good interaction can be achieved then the company will gain the most from all concerned. The chairman and other board members should consider the following issues and the individual concerned should also be asked to assess themselves. In evaluating individuals it is necessary to ask, for each non-executive director:

- How well prepared and informed are they for board meetings and is their meeting attendance satisfactory?
- Do they demonstrate a willingness to devote time and effort to understand the company and its business and a readiness to participate in events outside the boardroom, such as site visits?
- What has been the quality and value of their contributions at board meetings?
- What has been their contribution to development of strategy and to risk management?
- How successfully have they brought their knowledge and experience to bear in the consideration of strategy?
- How effectively have they probed to test information and assumptions? Where necessary, how resolute are they in maintaining their own views and resisting pressure from others?
- How effectively and proactively have they followed up their areas of concern?
- How effective and successful are their relationships with fellow board members, the company secretary and senior management?
- Does their performance and behaviour engender mutual trust and respect within the board?
- How actively and successfully do they refresh their knowledge and skills and are they up to date with:
 - the latest developments in areas such as corporate governance framework and financial reporting?
 - the industry and market conditions?
- How well do they communicate with fellow board members, senior management and others, for example shareholders. Are they able to present their views convincingly yet diplomatically and do they listen and take on board the views of others?

Evaluation of board committees

The emphasis on board committees, if not properly managed, can sometimes be divisive with committee members forgetting that they form a committee of the board, rather than a group which is divorced from it. Consider these questions, for example:

- Does each board committee have adequate and appropriate written terms of reference?
- Is the volume of business now handled by the committee (particularly the audit committee) set at the right level?
- Does the committee work in an 'inclusive' manner or has it, for example, resulted in executive directors not involved in the respective committee feeling distanced from those matters covered by the committee's area of activity?
- How effective are the board's committees? (Specific questions on the performance of each committee should be included such as, for example, their role, their composition and their interaction with the board.)
- Are board committees used to the best advantage? A more effective use of the nomination committee might be to widen its remit to embrace management development.

The decision to pursue evaluation

Backing from the chairman for both the evaluation and the form of the evaluation is extremely important. If evaluation is undertaken just for the sake of it—because the Combined Code requires it—the evaluation process may become difficult, superficial and, possibly, counter-productive. Although difficult to do in those circumstances, the recommendations which come out of the evaluation, provided they are well-founded, will probably still have an impact, but if the chairman is unsupportive of the process, or worse obstructive, it is likely to take longer for the directors to find their own ways to implement the recommendations.

Sometimes the board may, justifiably or not, take the view that it is performing well—so why bother with an evaluation. However, as implied above, it is a rare individual or board where there is no room for improvement. With these elements in mind, each company has to decide whether and if so how to go about its own evaluations. To do this effectively it needs to bear in mind the following:

- The chairman needs to give the whole subject his support—to do it just so that another 'compliance box' can be ticked, without the necessary commitment, would probably be a waste of money and could, in actual fact, do more harm than good.
- The board and every member of it, and any committees involved, need to know and understand the process that is being used.

- The chairman needs to have thought through what needs to be achieved. For example, does the board need a radical overhaul or just a “health check”?

A decision has then to be taken on each of the evaluations envisaged in the Combined Code²—the whole board; the audit, nomination and remuneration committees; and individual director evaluation—whether to carry them out “in house”, to use its own methods facilitated by someone outside the company or to use an external provider.

Each process has its merits and drawbacks. Some of the factors to take into account when choosing which method to adopt are:

(a) “In house”

This method has proved to be the preferred option for the majority of UK listed companies, especially for the first attempts at board evaluation, as it can cause the least concern to directors who are nervous of the whole idea. It has the advantage also of the in-house facilitator probably having prior knowledge of any ‘history’ and the different nuances that may exist in the relationships. Outsiders may not always pick up on these. When using this method, however, it is particularly important that the chairman is fully committed to the process; otherwise the results may be unfairly ‘influenced’.

For the board and committees, the process seems usually to involve questionnaires devised either in house or acquired from an outside source. The process might be led by the chairman, the senior independent director or the company secretary who will analyse the completed questionnaires. The results are then reported either to the board as a whole or, where he has not been the facilitator, to the chairman.

Individual director evaluation undertaken “in house” usually involves the chairman having either a structured or unstructured interview with each director. In some cases a questionnaire may be used which is completed by all directors with the results set out in a report on each director, compiled by either the chairman or the company secretary.

The “in house” approach may, however, be considered by some to be somewhat restricted and, if that route is chosen, allowance should be made for it, especially when reporting back to shareholders or in the annual report. Possible reasons for this include:

- The natural reluctance of directors to be completely open on sensitive issues with someone within the company.
- Where the process is entirely paper-based, there is no easy opportunity to get behind the initial answers to additional information or explanations.

² Principle A.6

- The coverage may not be comprehensive, not least because the answer to one question may prompt others not on the standard questionnaire.
- The board does not benefit from any comparison, even at a high level, of its performance with that of any other company.
- The approach may not be entirely acceptable to investors, since they are unlikely to be able to ascertain the rigour of the process used.

The outcome of an “in house” evaluation usually identifies the more straightforward areas which would benefit from attention and, whilst it may be considered restricted, it has its place. It is certainly better than not carrying out any form of evaluation and, as described later, may be particularly appropriate in years immediately following a full externally facilitated review.

(b) “In house” facilitated by an external person

This approach relies usually on questions either compiled by personnel within the company or provided from an external source, but the written responses are returned to and, analysed by, a third party. Whilst this approach introduces a degree of independence in the analysis, and may reveal the outline of more sensitive issues, it can still suffer from the other restrictions applicable to the “in house” route.

(c) External provider

The Higgs Report Performance Evaluation Guidance³ states:

“The value of an external third party to conduct the evaluation will bring objectivity to the process”.

So when might third-party involvement be useful to a board?

- **For new chairmen:** Incoming chairmen, especially if they have only been members of a board for a short time prior to their appointment, may find it useful to commission third party facilitation of an evaluation in order to accelerate, and render more objective, their own assessments of the board's capabilities and to plan future changes of the membership where this is envisaged.
- **For “old” boards:** Conversely, chairmen of boards which have operated with the same membership over a long period may consider an element of third-party facilitation as a safeguard against inertia or complacency.
- **When challenged:** Some shareholder lobby groups routinely criticise or challenge the tenure of certain directors on the basis of judgments which may be regarded as mechanistic (as per the ICGN reference to “box tickers”). Such challenges

³ Review of the role and effectiveness of non-executive directors, Annex J

are often ignored, often with good reason. The occurrence of criticism, however, may encourage periodic third-party evaluation which may, in turn, provide clear legitimisation of the decision to ignore it.

- **Every so often:** Although most boards may regard annual third party evaluation to be unnecessary, it may be that external involvement every two or three years will enhance the value of the regular, annual process. Periodic external facilitation may make it easier to solicit the views of the company secretary, HR director or other senior executives immediately below board level whose inputs would be compromised should they be involved in conducting the process. Senior executives may be (understandably) reluctant directly to criticise directors who are their employers and may be more likely to be candid in speaking with an external facilitator on a confidential basis.
- **When you know you have a problem:** For example, a situation which will require tactful, impartial handling.

Aside from the advantage of independence, the use of an external facilitator may make the process smoother and potentially less explosive. Such services range from highly structured interviews through to comprehensive analysis of the board in action. When evaluating external providers the following are just some of the points to which, it is suggested, particular attention needs to be given:

- The organisation and process used are proven and acceptable to investors.
- The provider can ensure independence and confidentiality.
- There are no potential conflicts of interest or vested interests.
- The qualifications of the personnel involved, i.e. do they have direct experience of board room practice.
- Interviews and reporting will be handled with tact and diplomacy.

Frequency of evaluations

As mentioned above, the Higgs Review recommended evaluation 'at least once a year'⁴ and the Combined Code refers to a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors⁵. However, the exact nature of each evaluation may well be dictated by the form and result of the evaluation that went before it. If, for example, as many companies have elected, an "in house" evaluation was carried out in year one then the board might be much more comfortable with an external appraisal in year two. If this takes the form of a comprehensive evaluation that finds few, easily solved, problems then year three may just require a light check to ensure that the situation has not deteriorated. If, on the other hand, year two identifies a number of very difficult issues

⁴ Review of the role and effectiveness of non-executive directors, Annex J
⁵ Principle A.6

then it is suggested that year three should be something more than just a "health check". In these circumstances the third year review should focus heavily on those issues previously identified, to ensure that they have been adequately addressed, with a lighter review of the remaining processes to ensure that matters have not slipped in other areas.

Accordingly, each year the board should consider carefully the extent and exact nature of the evaluation that is required as a full detailed evaluation may not be totally necessary or cost effective. Instead, as implied above, it may be more appropriate to work to a two or even three year cycle, with a form of "top up" comparison review in the intervening year(s) which would provide the company with a report on the progress which had been made on the findings and recommendations contained in the previous years' reports.

Benefits

Well conducted evaluations (whether conducted in-house or using an external facilitator) have the potential to achieve various benefits, helping the board to:

- Confirm that it has a suitable balance of skills and other attributes and focusing attention on the attributes required in any new director;
- Focus on any inadequacies;
- Identify strategic priorities;
- Develop skills, knowledge and understanding in the individual directors;
- Review its practices and procedures and thus to become more efficient and effective;
- Justify recommending the three yearly re-election of each director (where appropriate).

Being able to respond to prospective directors' due diligence enquiries by providing a copy of the board evaluation report may help also to attract the right people with the necessary skills and knowledge to help achieve the overall success desired.

The fact that an appraisal has been conducted should be reported in the annual report and accounts, together with details of the method used, as appropriate. There is no requirement to report or comment on any findings of the review, although the directors may wish to do so in some circumstances.

Principal findings from ICSA board evaluation experience

- There are often problems getting the optimum level of interaction between non-executive and executive directors. Lack of contact between meetings and some-

times a lack of understanding of the role of non-executives (particularly in smaller companies) are both contributors to this. If good interaction is not achieved then the company fails to gain the most from all concerned.

- There can be a lack of interaction between the non-executive directors and the senior managers outside the board, which makes it difficult for the non-executives to get a real feel for the business and to discharge effectively their responsibility for succession planning.
- Strategy awaydays are sometimes less effective than they might be because the process and outcomes of the previous awayday are not reviewed and insufficient attention is paid to briefing the board beforehand.
- Good succession planning – less than nine months after the current chairman (a former NED) had been appointed one board was looking ahead six years to finding a new chairman.
- Poor succession planning – a change of finance director and the lead audit partner within two weeks of each other.
- The volume of business now handled by the main committees, particularly the audit committee, has resulted in executive directors not involved in those committees feeling distanced from those matters.
- Volume of business is resulting in significantly longer meetings of the audit committee.
- Boards may have over-delegated (at least mentally) to the audit committee and, if they have one, the risk committee so that there is minimal board discussion of key issues beyond an oral report back by the committee chairman
- Excellent use of the nomination committee – its remit was widened to embrace top management development.
- Poor use of the nomination committee – a new executive director appointed from outside the company without reference to the committee; an executive director switched to an entirely different main board portfolio without reference to the committee; the committee was just not meeting.
- In some companies the executive directors, other than the CEO, do not act as full directors but more as department heads looking to the CEO to take the lead.
- Occasionally, where a small caucus of key directors gets on particularly well, the NEDs can feel like mushrooms (at least as regards light levels)!
- Many companies struggle, or have struggled, with getting the right level of information to the board. The optimum amount will vary from board to board depending on the type of business and the level of trust that has built up.
- Late delivery of board papers seems to be a recurring problem, with chairmen not always willing to intervene in respect of that aspect of their responsibility for managing the board.
- Few boards seem to conduct, even once each year, a robust review of the information which is being provided.

- Getting the optimum number of board meetings can be a problem – balancing the needs of the business with the time available from the best directors, particularly when there are overseas directors.
- Induction arrangements for new directors are variable in quality and effectiveness. Some boards are introducing refresher days for non-executives.
- The quality, frequency and volume of updating material can be patchy.
- There are instances where presentations are made to a board and then no time is available for discussion.
- PowerPoint presentations are not always preceded by a short note in the board pack summarising the highlights so as to allow directors to prepare. Clearly a note should be brief to avoid duplication of material presented to the meeting but the absence of any briefing can lead to directors misunderstanding the thrust of presentations.
- We encounter occasional complaints that “doing all this box ticking does not help the bottom line”—but recent scandals have served only to heighten shareholder concern that the companies in which they invest are being run soundly.
- Directors have welcomed the opportunity to stand back and look at how they work.

Conclusion

However a board chooses to carry out board, committee and individual director evaluations, it is necessary to consider:-

- who has the overall responsibility for the process (usually the chairman),
- who is going to have input into the process,
- the structure and content of the process,
- what reporting is going to take place and to whom, and
- most importantly, how the outcome will be acted upon by the board.

Overall, it cannot be stressed enough that it is essential that the purpose of board evaluations is to help **the board** do what **it** wants i.e. to perform to its maximum capability by creating shareholder value and maximising returns for shareholders. Evaluations must be supportive of the board and the directors, whilst being rigorous and even handed, in order to give the best results.

Finally, of course, it needs to be recognised that this is a continuing process. Most boards of big companies have now been through it once, so it becomes easier—not only because the natural concern about the unknown has been removed, but also because the period being looked at is confined to the period since the previous review, rather than the indefinite period being considered at the first evaluation.

About the Author

Simon Osborne is a Fellow of the Institute of Chartered Secretaries and Administrators (ICSA) and a qualified lawyer (Solicitor, England & Wales). He chairs ICSA's Company Secretaries Forum and is director of its Board Performance Unit. He has worked successfully with major companies, UK financial regulators and other organisations and brings first hand knowledge and understanding of the practical and personal aspects of the operation of boards and how to identify performance improvements. He co-directs ICSA's "Non-Executive Directors' Programme" and is a member of the International Corporate Governance Network. He speaks on practical corporate governance topics at conferences and seminars.

Simon is a non-executive director of Crown Business Communications Limited—a multi-disciplined, award winning corporate communications agency—and of its parent, MNN Holdings Limited. In addition, he is a director of RT Group PLC.

Up until April 2003 Simon's career was in the UK railway industry, where his final assignment was as a main board executive director of RT Group PLC (formerly Railtrack Group PLC). Previously he had been company secretary and general legal counsel of the Railtrack Group. During this lengthy experience through turbulent but exciting times in the company, Simon established himself as a "wise friend" for executive and non-executive directors.

In the voluntary sector Simon is deputy chairman of the principal railway industry charity, the Railway Benefit Fund.

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