

Guidebook for
Development
Finance Institutions
**on Nominating
Members
to the Boards
of Investee
Companies**

-
September 2016

Disclaimer

This Guidebook has been undertaken in an effort to represent different views of different institutions. The actual practices of each of the institutions involved in drafting this Guidebook, namely DEG, EIB, FMO, IIC, IFC and PROPARCO, may still differ from what is described or recommended. It thus does not represent the views of any particular institution.

Although this Guidebook aims to be as comprehensive as possible in the breadth of its analysis, it should not be relied upon as professional advice on legal, governance or compliance related matters.

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Acronyms or abbreviations

AC	Advisory Committee (<i>in a PE fund</i>)
CG	Corporate Governance
CGDF	Corporate Governance Development Framework
DEG	Deutsche Investitions- und Entwicklungsgesellschaft (<i>German Development Bank</i>)
DFI	Development Finance Institution
D&O	Director & Officer
e.g.	exempli gratia (<i>for example</i>)
EIB	European Investment Bank
etc.	et cetera
FMO	Dutch Development Bank
GP	General Partner
IC	Investment Committee (<i>in a PE fund</i>)
i.e.	id est (<i>that is</i>)
IIC	Inter-American Investment Cooperation
IFC	International Finance Corporation
LP	Limited Partner
OHADA	Organisation pour l'Harmonisation en Afrique du Droit des Affaires (<i>African organisation on the harmonisation of business law</i>)
PE	Private Equity

Table of Contents

What is the purpose of this Guidebook?	5
Who is the target audience of this Guidebook?	5
What was the interest of the CG DFI Working Group in drafting this Guidebook?	8
What were our guiding principles?	9
Individual board seats in corporations	11
Why do we nominate directors to the corporate board of an investee company?	11
When do we nominate?	12
How do we nominate?	13
Who do we nominate?	14
Responsibilities of all parties involved	16
What are the responsibilities of the nominee director?	16
What are the responsibilities of the nominating shareholder?	17
What are the responsibilities of the investee company?	18
Alternate Directors	20
Observers	20
Who should pay the nominee director and how much?	21
How should the nominee director be protected?	22
How many director seats and committee seats can a nominee director have?	23
Potential conflicts that need to be kept in mind	27
How shall the nominee director report or share information?	28
How should the nominee director be monitored?	30
Who is responsible for monitoring the board performance?	30
Does the nominating shareholder have a responsibility for the nominee director?	31
The exit of a nominee director	33
When should the nominee director resign?	33
Who is responsible for revoking the directorship?	33
Corporate/institutional board seats	34
Executive positions of a nominee director	34
Nomination to bodies of a private equity fund	35
The role of the nominee in the advisory board/committee	35
The role of the nominee in the investment board/committee	36
Corporate fund structures	37
A word to the wise	37

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“Directors should be advocates of sound governance principles. This is especially important in challenging times or when the company is in crisis.”

William George
in **McKinsey Quarterly February 2013**

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What is the purpose of this Guidebook?

Development Finance Institutions (DFIs) offer diverse financial products to companies in emerging markets. In turn, they frequently—in particular with equity-type investments—obtain the right to nominate one or more non-executive board member(s) to the (supervisory) board of directors of either the investee company or the investment fund.

The purpose of this guidebook is to provide guidance on how best to fill such positions and how to deal with potential dilemmas and related conflicts of interest. The focus will be first on non-executive¹ positions in corporate boards of investee companies; we will then address executive positions and the participation in fund-like investment bodies, such as an advisory or investment board/committee.

Whenever we refer to a ‘board of directors’ we mean either a two-tier supervisory board involving only non-executive directors or, alternatively, a one-tier board involving both executive and non-executive directors. The role of the nominee director does not depend on the type of supervisory board; in both cases, the nominee is expected to fulfil the classic non-executive role of supervising the executive management and providing strategic advice together with his or her fellow directors.²

The guide is written from the perspective of professionals in DFIs. The term ‘we’ appears throughout the document and refers to the DFI perspective.

Who is the target audience of this Guidebook?

This Guidebook is drafted for colleagues in development finance or like-minded institutions who are involved with directorship positions in an investment. There is possibly a particular interest for colleagues in private equity (PE) departments, since directorship positions are mainly offered or negotiated in equity-type investments and, less so, in a debt-type investment. Moreover, corporate governance (CG), legal and compliance departments may have a particular interest in the contents of this Guidebook.

The contents of this document are relevant to nominee directors as well, who would likely be interested in the nomination process, guidance on how to handle dilemmas, and the rationale behind decisions made by DFIs when nominating Board Directors.

1

By the term ‘non-executive’ we refer to a position that is not involved in the executive/leadership/operational team of the company and not a full or part-time employee.

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This default case we are going to describe still needs to be differentiated from the case in which the nominee is offered an executive role in the management board rather than the supervisory board or, likewise, an executive role in a one-tier board.

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DFIs have the
unique mandate
to create development impact
through their investments
by adding value to their
investee companies.

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What was the interest of the CG DFI Working Group in drafting this Guidebook?

DFIs have the unique mandate to create development impact through their investments by adding value to their investee companies. In all jurisdictions—at least as far as we are aware—there is the legal duty of a board member to act in the best interest of the board's company. The first dilemma that board members appointed by a DFI face is not to prioritize the potentially conflicting interest of the constituency that has nominated him or her over the interest of the investee company. This dilemma is exacerbated when the nominee is a staff member of the institution that is designating him or her, since individuals tend to be automatically aligned with institutions as employees. Furthermore, DFIs often provide several products simultaneously, with different underlying risk profiles (e.g. debt and equity), which may again further exacerbate the conflict of interest situation.

In this Guidebook, we aim to take stock of dilemmas of this nature, provide suggestions and different alternatives to consider without necessarily prioritizing one. The guide should, therefore, be read as a discussion of various issues to consider. It is meant as input for a development finance institution's own policy on directorships or other corporate positions. We hope to contribute to the debate that tends to take place in DFIs when drafting these policies by addressing the main issues that we have been confronted with in our own experience. The Guidebook is intended to be a living document, and we hope to update it to reflect new insights stemming from the experience of an increasing number of DFIs that engage in (and more carefully consider) the practice of nominating members to boards of investee companies.

What were our guiding principles?

The legally universal concept of fiduciary duties of board members is the main guiding principle for our considerations. These duties, however, need to be balanced with the DFI's institutional goals.

On the one hand, when addressing some of the challenges and dilemmas, we follow our DFI mandate which is to create value. With any particular investee company, we contemplate how to improve their operational standards and governance practices to create value in the long term and vis-à-vis stakeholders and shareholders alike. In the attempt to define the role of a nominee director, we ask how a director in particular can contribute to this value creation. We consider which expectations a nominee director is confronted with, either from the investee, its shareholders, the nominating shareholder or even from fellow board members. On the other hand, we do not necessarily favour a particular model of CG. We do acknowledge

that there is a public equity-type model favouring an independent board and a PE-type model that favours shareholder representation on a board either in addition to or, less frequently, in lieu of independent³ directors. Depending on its maturity stage different models may offer different advantages. We see governance as a 'journey', rather than a 'destination', so the best governance set-up for a particular company needs to be modified as the size, complexity and structure of the company changes. Yet, most of the dilemmas we are dealing with arise from a PE approach in which shareholder representatives sit on boards of investee companies. DFIs have additional challenges to consider when adding shareholder representatives to the boards of their investee companies, both because their investment products have different underlying risk profiles and because they are less operational than their mainstream PE colleagues.

An independent director is a non-executive board member who has no affiliation with the investee company other than his or her board seat. Different jurisdictions provide for different definitions often combined with thresholds at which a board member is not (!) considered independent. A good example of such a definition is the one of the International Finance Corporation: <http://bit.ly/1F0OhVz>

In general, substantial shareholding, existing or previous employment status, supplier or customer status and family membership can disqualify independence.

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“Nominating the right people at the right place is imperative in contributing to making better decisions in the board room.”

Martin Steindl,
Chair of the DFI CG Committee on Directorships

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Individual board seats in corporations

Why do we nominate directors to the corporate board of an investee company?

In principle, there are several reasons for nominating directors. As mentioned, we focus here on the default scenario of a direct investment in a corporation with a one-tier or two-tier board structure for which a nomination right as a non-executive to the (supervisory) board is offered. The considerations can be summarized as follows:

- adding value by supplementing a (missing) skill or experience to the board (consider a board evaluation on skills and performance); in other words, focusing on the possible development impact at company level;
- portfolio monitoring performing an internal oversight function at the level of the DFI;
- using the directorship as skills transfer to learn more about the country, the industry, the region – potentially — but not limited to — developing new business opportunities.

Historically, DFIs have focused more on the latter two targets while now the first one is considered more important. As a matter of fact, not all these targets can be met at the same time, and there may be other targets as well. The core challenge is, indeed, that some of these targets may be conflicting at times. As mentioned, a board member should act in the best interest of the investee. Monitoring the investment and developing new business opportunities may at times be more in the interest of the DFI than the investee. We would thus suggest for a DFI to define and prioritise the target that is most relevant in each investment.

Regardless of how the decision is made, one key aspect is always to align the DFI's expectations with those of the investee. We encourage transparency in

communication and aligning your targets with the investee to avoid misperceptions and conflict. At all times, be aware of the guiding principle that the nominee director owes his or her fiduciary duties to the company and all its shareholders (and at times stakeholders) and not to one particular nominating shareholder, and there is also a duty of confidentiality connected with this. Nominees are generally serving in their individual capacity and are thus subject to personal liability. Therefore, individual nominees should not be 'sacrificed' for the sake of a DFI's institutional goals that may be in conflict with the above mentioned guiding principle.

When do we nominate?

In making a decision when or in which cases to nominate a director, it is important to consider various key issues related to the legal environment, logistical arrangements, investment type suitability and the particular requests of the client. While we like to encourage a transaction-specific analysis, the following aspects can support a decision in all cases:

- **Investment structure:** (typically) candidates are nominated in direct equity or equity-type mezzanine investments. But alternative constellations can support different decisions, e.g. in mixed cases (debt & equity) or rather debt focussed mezzanine instruments. Given the different underlying risk profile we would not recommend nominating a director to the board in the case of plain vanilla debt instruments.
- **Opportunity versus liability:** which actual or potential costs might be involved in nominating a director (e.g., listed investments or heavily regulated investments)? Nomination in financial institutions, in particular, often requires a lot of time and effort for the vetting process with the local central bank. Additionally, a broader issue to consider is what the potential liabilities in the country are, whether the associated risk is worth the anticipated governance benefit, and whether the nomination is fit for purpose.
- **Investment partners:** If several DFIs are involved whose interests are, more or less, aligned, it may be worthwhile to consider nominating one on behalf of several DFIs if one nominee director could achieve targets for multiple investors. It is often the case that several DFIs nominate directors with similar backgrounds and skill-sets to the board of the investee company. Therefore, it is worth considering having one or two DFI-nominated directors, thereby making room for other types of directors with different experience or skill-sets.
- **Operational environment:** Consider which rules are implied by the regulatory and legal environment. Does the local environment

support or object to a right to nominate a director? How easy is it to access information and to attend meetings? The meeting frequency itself may determine which type of board member to send (local versus international) to facilitate meaningful participation.

- **Investment terms:** How relevant is the investment to your portfolio (given the ticket size or shareholding percentage)? Quantitative thresholds (e.g. > 10% shareholding) can serve as reference. If, for example, the equity position is below 10%, many DFIs do not even negotiate the right to nominate a director.
- **Potential for the DFI to add value:** the DFI is encouraged to again carry out a critical analysis of the motivations behind nominating a board member. If and when the main motivation is access to information for the purposes of monitoring the investment rather than adding value, the DFI is encouraged to explore other options with the investee whereby the communication and information sharing is strengthened through shareholders' meetings and shareholder agreement.
- **Role:** After defining the objectives for the nomination, carefully assess if a nominee director is best suited to add value or if knowledge and/or resources could be added differently. Consider that directorships in different jurisdictions as well as in different stages in a company's development impose different requirements and potential liabilities / risks (e.g. pre-IPO or IPO scenario or a distress situation). Distinguish between corporate or personal mandates – in most jurisdictions the personal mandate exists, in other words, the nominee director is acting on his or her own behalf and in his or her individual capacity, which can impose different responsibilities and liabilities depending on the local legislation. The role of a nominee director may also differ significantly in view of the stage of maturity of the company;

early stage companies may require more operational input and access to networks than monitoring and proper controls. Thus, it is useful to ask yourself what type of company you are dealing with (listed vs. unlisted, privately-owned vs. state-owned, a company in distress) and what the role of the board is (how the role has been defined, how involved the board is in day-to-day management, and which skills are required by the board at the present phase of the company's development).

Overall, we would suggest having a nomination right in case of a 'significant' direct equity investment ('significant' may be defined as a percentage around 10% of equity). Based on the initial analysis and set targets, a nominee director shall be equipped to achieve those targets (by having adequate time, skills, and expertise available).

How do we nominate?

This question refers mainly to internal considerations. While the external process and especially all regulatory requirements (including "fit for purpose" tests, applications, a clear distinction between nomination and appointment⁴) are highly important, they need to be assessed separately for each country and industry. Internally, the following aspects could help define the internal selection process:

- When do you analyse and define the goal of a directorship and the initial objectives for a particular nominee director? (Consider different stages in the approval and analysis process.)
- Who selects a potential candidate and who approves the nomination? (We feel that the investment team should be involved, but a decision should be taken by a more senior person, i.e., at least two hierarchy levels above the investment officer.)

- What particular risks are present in the specific jurisdiction where the nominee will be operating? When nominating a board member, it is advisable to complement the legal due diligence carried out by the project attorney with the analysis of local legal counsel based in the country of reference.
- Who is responsible for administering and overseeing all directorships? Not only from an operational risk perspective; someone should know at all times how many, which kind and in which legal entities directors have been assigned to. A practice worth considering is bringing together all nominee directors from the DFI periodically to share experiences and discuss how dilemmas have been dealt with.
- Does the compliance department have to be involved to vet the profile and background of an external candidate?
- How should the objectives of the nomination be defined between the investee company, the nominee director and the nominating shareholder? A potential consideration can be a nomination letter stipulating the objectives between all parties involved.)
- Are there external requirements and processes to be taken into consideration in order to avoid conflict between internal decisions and processes and local legal requirements?

If you follow a formal internal approval process before nominating a candidate, define the information required to actually take such decision which should include, but not be limited to, the why, when and who. Such a process should also kick in in case of a necessary renewal of the nomination and should document any on-boarding and handover undertaken.

A board member is, in most jurisdictions, only appointed by a shareholder vote. The 'nomination' of such director needs to be seen distinctively from the appointment; the former only defines the right to put a name forward, but not to directly appoint the director. This has an interesting consequence; in case that the nomination is revoked, as long as the nominee him- or herself does not resign or the majority of shareholders support the withdrawal, s/he will remain a director on the board. This consequence led some DFIs to have the nominee sign a blank resignation that they could use at any point of time. Such measure strikes us as rather drastic, as we consider it may seriously hamper the perception of a nominee's independence from the nominating institution.

Who do we nominate?

After assessing the why and defining the objectives of the nomination, a suitable candidate has to be identified. Our main recommendation here is that each candidate should be selected based on the prior analysis and skill set required. In fact, each nomination should be similar to a job application process which includes defining the role and job specifications, the terms offered for employment (remuneration, time requirement) as well as the skills needed (experience, hard and soft skills, cultural and behavioural knowledge, willingness to travel) as well as availability (depending on other engagements and residence location of the candidate). Considerations to define the profile of an ideal candidate may include:

- Defining job specifications based on the overall objectives (assessing which skills and experience are already available in the board and which skills and experience are lacking). With regards to this point, it is very helpful to have a comprehensive analysis of the structure and functioning of the investee's board of directors such as the one that takes place during a CG assessment;
- Taking into account those objectives may change during the investment holding period and different situations may require change;
- Evaluating each candidate's skills (e.g., industry, management, cultural, personal, language) based on the particular job specifications;
- Considering the fit with the rest of the board members, possible cultural implications and future boardroom dynamics on the one hand, but also aspects of board diversity on the other hand;
- Accessing a broader pool of talent by considering retirees, internal or external candidates

The latter aspect is the most exciting and challenging one. A DFI needs to ask itself critically whether (internal) staff members are best suited for all types of board positions. There are several considerations to be factored in when determining this. First and foremost, time commitment and rotation. Many investment officers keep their regional or industry assignment for less than three years. In addition, most likely, there will not be additional remuneration and time made available for exercising board positions. Furthermore, the investment officer may be physically very distant from where the board meetings actually happen. Finally, the skill-set of investment officers may always be similar with a focus on finance and investment but not necessarily offer the industry expertise or other operational or strategy experience needed on a board. On top of these preliminary considerations, the potential for conflicts of interest, in particular if the DFI provides different investment products, is also higher with staff members. All that said, depending on the objectives of the appointment, a particular board seat could still best be filled with the profile of an investment officer, in particular for early stage companies that need a lot of operational support, provided the investment officer is indeed in the same vicinity.

Currently, few DFIs have ventured beyond their own staff and created their own cadre of external candidates. Smaller institutions probably find that cumbersome. The advantage of an external nominee is, of course, the potential for more 'independence'⁵ and a bigger variety of skills and experience made available to the investee company. This, however, comes at the 'downside' of less influence on such a director and less knowledge of the nominee on the DFI's internal strategy and processes.

5

That said, even an external candidate cannot easily be considered an independent director in the classic sense given the right to withdraw the nomination at any point of time by the development finance institution that affects his or her independence, and also often because of the practical support provided by the development finance institution for the remuneration package.

We would not recommend limiting a DFI to one of the two pools of candidates, namely internal or external candidates only, but would definitely encourage tapping resources other than internal staff members alone. Most important is, indeed, the analysis of what the investee actually needs. If this analysis is done in a proper and objective way, it will usually automatically point out that a profile different from the DFI's own staff members is needed.

Retirees can be a good starting point to build a cadre of external candidates. They also offer the advantage that they know the DFI very well while not being exposed to the same potential conflicts of interest as an existing staff member. Yet, in such cases, a cooling-off period between retirement and the nomination for a first board seat may need to be considered to achieve the above mentioned objective of more independence from the DFI.

Lately, some DFIs more actively drive a board diversity agenda. Board diversity is defined as the percentage of women (but also other minorities in the workforce) having a seat on boards of directors. Research indicates that board diversity is associated with improved financial value.⁶ For example, one DFI strives to have 50% of their own board nominations being women and have currently achieved 30%. While boards in emerging markets often face a myriad of challenges, board diversity should not be considered a secondary concern.

6

Carter/Simkins/Simpson, Corporate Governance, Board Diversity, and Firm Value, SSRN-id304499

Responsibilities of all parties involved

What are the responsibilities of the nominee director?

A nominee director, in case of an individual assignment, has to take several responsibilities into account. Most important is to be aware of his/her fiduciary duties as a nominee director. Those duties are normally defined as a duty of loyalty and a duty of care but they may (slightly) vary depending on local laws. Those duties normally mean to act with good care, in good faith and in the best interest of the investee company and all shareholders and, where relevant, to also consider stakeholders' perspectives and interests.

In case of a corporate /institutional board seat⁷, the above-mentioned duties formally lie with the institution but should to the widest extent be translated into duties of the individual actually representing the institution. To which extent the institution and the individual representing the institution can practically act in the best interest of the investee company at potential expense of the institution's interest in case of a conflict is, however, tricky to address.

Understanding the local environment and analysing the requirements before accepting a nomination is key for the nominee director, but also something the nominating DFI should bear responsibility for as well as actively facilitate. Equally important for a nominee director is to thoroughly understand the company and its operating environment. The DFI should ensure a professional on-boarding process, in which the nominee director has a chance to read the most important corporate documents, but also holds interviews with the other directors and the executive suite of the company, including the company secretary.

In addition, the DFI should ensure that the nominees have received formal CG training as part of their on boarding process. The institution can provide such a training directly or arrange to have the nominee attend an external training.

Further responsibilities relate to the practical work as a nominee director and include, among others:

- attending (all) board meetings
- being responsive
- being prepared and focused at board meetings
- ensuring that sufficient information is available to make board decisions
- constantly reflecting on his or her role and the potential engagement in committees considering necessary skills and time required
- transparently managing any conflicts by flagging them early on, avoiding them if possible or otherwise mitigating them
- engaging actively with management and fellow board members
- delivering on the objectives stipulated in the nomination (being aware of potential conflicts and applicable regulations)
- managing any (information) requests from the shareholders according to applicable legal restrictions

What are the responsibilities of the nominating shareholder?

As the nominating shareholder, the DFI should first appreciate the role of the nominee director as a board member and the fiduciary duties involved. At the beginning of the directorship, it is important to agree on the overall objectives for the directorship and manage expectations. Such objectives should be mentioned in the nominating letter (and also the corresponding letter to the investee) and provide the basis for communication between the nominee and the DFI. Examples for adequate objectives are, for example, 'enhancement of the internal audit procedure', 'improvement of E&S risk management systems', 'enhancement of process to define and implement strategy', etc. The DFI is encouraged and may arguably even be obliged to provide or facilitate a brief training for the nominee that includes the duties and responsibilities of board members and best practices and principles in CG.

In particular, communication between the nominee and the DFI is an important topic that needs to be clearly defined, also vis-à-vis the investee company. We will address this issue later separately under pages 28. Finally, an agreement on compensation, insurance and indemnity also needs to be reached where the DFI may decide to provide additional support. Such issues are also explained on page 22 onwards.

Moreover, at the beginning it is important to facilitate a knowledge exchange about the legal environment and regulations for the nominee director. Some DFIs provide access to their local lawyers, others have, at least, a legal questionnaire that is shared with the investee to provide further insights into the overall regulatory environment and existing fiduciary duties.

More recently, negligent performance of certain obligations of a director can also trigger criminal prosecution in some countries, in which case particular attention needs to be given to ensure that the nominee is fully aware of those obligations. Furthermore, the nominating shareholder should ensure that the investee company provides for an on boarding process that includes the provision of certain key documents but also the undertaking of interviews with the C-Suite⁸ of the investee and the company secretary.

One complex topic is deciding on the information that the nominating shareholder should share with the nominee. Two conflicting considerations need to be taken into account. On the one hand, since a nominee director practically remains to be associated with the nominating shareholder it is at times considered inappropriate if s/he is not aware of certain actions taken by the nominating shareholder. On the other hand, one board member should not necessarily have an information advantage by one shareholder over the other board members. We would thus recommend that the nominee is kept abreast of certain country- or industry related strategies of the nominating shareholder that would affect the investee company. If certain steps are taken by the nominating shareholder from a portfolio management or shareholder point of view, the default solution should be to treat all board members equally instead of alerting the nominee director.

Another question to consider related to the topic of information sharing is the extent to which internal investment-related documents, such as the investment proposal, should be shared with

the nominee director. Since the director's is not appointed at the point of time of the nomination as well as because of his ultimate fiduciary duty towards the company, most DFIs consider such material confidential vis-à-vis the investee and, thus, also vis-à-vis the nominee director. Yet, the financial proposal is possibly the best source for the nominee to have a critical view on the investee company and also understand further important topics, such as E&S or compliance. While legally challenging, we would encourage sharing these internal decision documents (at least in part) with the nominee director, or providing access of the nominee to the investment team and all specialists involved in the due diligence for the financing in the investee company.

As the directorship progresses, the nominating shareholder should provide ongoing support and training. An annual gathering of all nominee directors for networking purposes or other training opportunities are appropriate ways of staying in touch with a DFI's cadre of nominee directors and the overall strategy of the nominating shareholder. Apart from such support, the nominee and the DFI should agree on how to monitor the implementation of the objective and how to evaluate the directorship. Since the nominating shareholder is not part of the board meetings, it should shy away from a formal evaluation, but ensure that a board evaluation does take place. Also here, however, results should not necessarily be shared with the nominating or any other shareholder, but the evaluation exercise itself should establish sufficient trust in the efficiency and effectiveness of the board and its members. (See further under pages 30).

What are the responsibilities of the investee company?

Naturally, the investee should also respect the fiduciary duties of each of its directors and understand that the nominee director is not acting on behalf of the nominating shareholder but in his or her own individual capacity.⁹ Adequate information about the regulatory environment and respective fiduciary duties should be provided continuously to the Board members as this is essential for adequate decision-making at the board level. The existence and properly defined role of a company secretary may be paramount to ensure adequate and timely provision of information to the board.

As mentioned before, it is the key responsibility of the investee company to arrange an on-boarding process. Normally, this entails the provision of key documents as well as interviews with the entire C-Suite, fellow board colleagues and maybe even clients. The nominating shareholder should spare no efforts in bringing the new nominee up to speed with the company as soon as possible.

In general, the investee should provide for remuneration, indemnification and D&O insurance. With many of our investee companies, however, these may be entirely new costs that they haven't factored in so far. In particular, if the nominee is perceived as a shareholder representative, the investee may be resistant to the idea of paying the nominee director. Another issue is that even if board members are remunerated, it may not be at a level at which adequate (international) expertise could easily be added to the board. In particular, in many Asian countries the ongoing practice is still to pay sitting fees which do not match adequate board

remuneration for the overall time committed by the nominee. In such cases, it is up to the nominating shareholder to support remuneration and also insurance. It should be noted, however, that the investment team needs to negotiate early in the process to ensure that the investee provides for remuneration, indemnification and insurance. Only in exceptional cases and for a limited period of time can the nominating shareholder contribute to board fees. With regards to D&O insurance, depending on the existing legal risk, the nominating shareholder may decide to waive the requirement of D&O insurance for a year or so. However, this would only be possible in cases where the DFI provides its nominee with protection while the individual is not covered by another policy. While ideally all non-executive directors would obtain the same level of basis remuneration for being a board member, at times, the nominating shareholder may need to top the compensation for its member in order to bring specific expertise to the board.

9

In case of a corporate position, the nominee acts on behalf of the nominating shareholder and not in his or her own individual capacity but shall also respect fiduciary duties towards the investee company; see further below page 34.

Alternate Directors

In the case of an individual board membership, some jurisdictions may allow for the nomination of an alternate director. Some may even make this an obligatory condition—in particular in Latin American countries such as Paraguay or South Africa, for example. In the former case, where the alternate director is not compulsory, we would rather refrain from such an additional nomination. The board seat is an individual obligation and the quality of the board rests with its members and relies on their regular participation in board meetings. Alternating membership can only be disruptive here and does not offer any advantage other than for the principal to be ‘officially’ allowed to skip board meetings. Also, liability questions are not satisfactorily solved, for example, to which extent participation in decisions of the alternate also make the principal responsible and vice versa. Finally, the information exchange necessary between alternate and principal can be challenging, in particular if the alternate is only needed once or twice a year.

In practice, we have observed a misuse of the concept of alternate directors. An investee company was frequently promised an international expert in a certain subject area and the local country manager, often a generalist, became his or her alternate director. Rather than being absent once or twice a year, in practice, the international expert never showed up for a board meeting and the investee was ‘stuck’ with the less specialized alternate director. Our recommendation is thus to avoid alternate directors unless legally required. If legally required, it’s important to flesh out in some detail how the principal should keep the alternate informed and vice versa.

Observers

There are several concerns likewise with the concept of a board observer. Also here, it is important to check the specific legal environment first. There may be countries in which board observers are not allowed of which we are actually not aware of. In general, however, it’s hard to be an observer only, not speaking up or influencing the board in any manner. So frequently observers will practically act in the same way as a full-fledged board member sharing their views and at times even fully participating in the discussion thereby breaching their role as observers. In such a case, while acting and behaving similar to a ‘regular’ board member, the observer does not share the same fiduciary duties. If, on the other hand, an observer is indeed only observing and doing nothing else, even being silent while observing a disastrous decisive turn at the board, the question arises to which extent s/he is really useful for the board. Not sharing the same fiduciary duties, s/he may be the only person in the room fully aligned with one shareholder but not with the rest of the board which may prove to be only disturbing or even disruptive for the dynamics of board meetings. Often DFIs only get the status of an observer offered because of the already existing high number of board members. Yet, if the observer is expected to behave just like a board member the argument of board size is not valid. Practically, the observer is then (behaving) just like another board member. We thus recommend that the investment team should avoid settling on observers and instead require full board membership for a nominee, even if this proves to be challenging for the overall board size.

In some countries there is also a legal risk with regards to observers. If they regularly attend board meetings, they may be regarded as ‘shadow directors’ and, as a consequence, become fully liable for board decisions.

While formally not being a director, investment officers may still like to attend board meetings from time to time. However it is then important to be regarded as an invitee (and not as an observer¹⁰) and not attend every, or even every other board meeting (in other words, trying to avoid any pattern in board attendance). Although, in general, we do not recommend appointing observers for the reasons outlined above, if the underlying finance instrument is debt and the DFI is set on being present at Board meetings, then we believe an observer seat is more appropriate than a board seat, especially if it is clear that the observer represents the interests of the debt provider.

Who should pay the nominee director and how much?

Remuneration levels as well as practices vary substantially even within emerging markets. Non-executive directors should be reimbursed for their reasonable expenses (travel costs and accommodation) and should also receive a fee. Best practice would consider this an annual lump sum (in cash or cash plus a small amount of shares¹¹) without any other performance element (stock options, bonuses, etc.). The annual lump sum should be a consideration for the time commitment of a nominee director. Being a board member is not only about attending board meetings. It may include annual general meetings, company events board committees and visiting company facilities but also general information updates and phone calls. The fee will

thus be higher in case that the nominee director is involved in committees, chairs one or more committees or is the chairperson of the board. As a rule of thumb twice to three times the time that is spent in meetings is needed to prepare and stay abreast of company developments. Internationally, for non-financial institutions, the time commitment for non-executive directors is above 20 days a year, for banks it is even above 30 days. The average remuneration for a non-executive director of a listed company in Europe is around 82,000 Euro.¹²

Both daily time commitment and annual lump sum may be somewhat burdensome for the markets and companies in which a DFI operates. As mentioned, in many markets in Asia, the nominee director only receives a sitting fee for each meeting s/he attends that may—even in the case of additional involvement in committees—not exceed an annual fee of Euro 5,000. This practice is not ideal, on the one hand because it does not adequately remunerate the director for his or her needed time commitment and also because it rewards physical presence without adequate preparation.

Under such remuneration arrangements, directors also tend to sit in more boards to increase their overall fee with the downside of spending less time on each company. In addition, in these markets board members will often be retirees, since, for active professionals, the cost/benefit analysis does not even come close to break even.

So, the starting point of adequate board remuneration needs to be to convince the investee that it needs to cover not only expenses but also a fee that should be equal for each board member and should be higher in case of committee involvement or one or more

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10 If an IO really feels that s/he needs to be an observer, it’s recommended not to be mentioned in the minutes to avoid any legal liability as shadow director.

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11 The problem of a payment in shares in general is that it may also affect independence of a non-executive and independent director at a certain percentage of overall share possession. As noted later, internal staff should neither receive cash nor shares.

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12 See The Hay Group, Non-executive directors in Europe, December 2014. Of note is that listed companies (and also financial institutions) pay in general substantially higher board fees than non-listed companies, which are the bulk of a DFI’s clients.

(committee) chair position(s). In order to assess a proper board fee, an internal and external test could be undertaken. The latter would be to find a market reference of a listed company ideally in the same industry and country (that publishes such information). The former would assess the overall time commitment needed in terms of days per year: As mentioned above, take the time in meetings as half or one third of the overall time spent during a year and multiply it with the daily salary of the CEO or some other very senior person in the company or an international consultant if you want to pay similar fees in different countries.

If in a scenario in which such a reference fee is higher than the annual amount received in sitting fees, the nominating shareholder may decide to cover the difference to ensure for adequate expertise and time commitment of the nominee on the board. The investee should cover reasonable expenses in any case. Of note is that money is of course not the only motivation. A nominee may be equally attracted by the fact that s/he is selected as board member on behalf of the DFI or interested in the country or industry exposure. In such cases, an addition to the board fee may not be needed. The downside of remunerating one director adequately is that others may expect the same level of remuneration. Having said that, it is important to acknowledge that a good candidate should not be dropped just because the remaining board members receive a (substantially) low(er) sitting fee.

If and when staff members sit on boards, most DFIs oblige them not to keep the board fee, if they receive any. It is either waived or goes to the nominating shareholder or is donated. This practice avoids an internal race to get board seats because of additional financial rewards and is also relevant from an income tax perspective. Yet, it creates the downside that staff members also need to be highly self-motivated to fulfil their board obligation(s). If staff members are board members for investees in a different department, their managers may also not be supportive of these positions since it eats into the time they should devote to their department.

How should the nominee director be protected?

There are two levels of protection, namely indemnification and insurance. Both should be provided at the level of the investee company. Consideration should thus be given as whether the investee company has taken out adequate and sufficient director and officer liability insurance (D&O insurance). It is particularly important to check the ceiling of liability claims which should be at least at 1 million USD. With regards to indemnification, we recommend that the DFI provides additional indemnification—on top of indemnification potentially provided by the investee company—through a specific Indemnity Letter. In such a letter, the DFI should limit the liabilities to any action, suit or proceeding, including those threatened or pending, whether civil or administrative. This is necessary to avoid any doubt that this indemnity does not extend to dishonest or fraudulent act, gross negligence, wilful misconduct or reckless disregard of duties and obligations. Such clause may be incorporated in the nomination letter and may read as follows:

'As from the date hereof, xxx DFI will fully indemnify you in respect of any and all costs incurred pursuant to court judgments, penalties, settlements, reasonable costs and other liabilities in connection with any claim, complaint or proceeding claims made against you by third parties in respect of you holding an xxx DFI nominated corporate position, subject to the conditions set forth in the attached Indemnification Statement.'

While such indemnification is best practice, it can potentially create a misalignment among board members with different liability covers. It has to be assessed in each respective situation whether an institutional indemnification by the nominating shareholder should be disclosed.

In case of a corporate position, if permitted by law, the potential liability can be shared between the institution and the individual being nominated to act on its behalf. Should a claim arise, liability would lie first with the institution. In case of fraudulent behaviour of the individual or other forms of wilful or grossly negligent conduct, however, the individual would still be held fully liable.

How many director seats and committee seats can a nominee director have?

Best practices vary as to how many boards seats one person can possibly hold. It also depends on the type of company and whether the person still has an active professional life, i.e. a full time job. Chair and committee positions may also reduce the possibility to have more board seats in other companies. On the other hand,

several board seats within a group may be clustered into fewer ones but the DFI has to carefully assess whether there is indeed a lesser time commitment required if one sits on several boards of a group. Although we are not in a position to recommend a specific number of board seats and/or committee seats for any specific individual, we do believe this is an important matter for the DFI to consider, and that appropriate thresholds in terms of number of seats and maximum duration in the post should be considered and defined. Below we include some considerations that may be useful in defining these thresholds.

In general, the time availability and commitment of each candidate needs to be considered. Moreover, liability may vary if the nominee, for example, sits on the audit committee or chairs such a committee or the overall board. Again, a first orientation can come from the corporate governance code for listed companies or CG regulation for banks to obtain an insight into how many board seats the nominee can hold. Yet, since the DFI works with a cadre of nominees world-wide it should also define its own thresholds, ideally in a more conservative fashion to avoid adapting for each and every country. (For example, if the DFI allows its nominees to sit on 15 boards it will need to check whether there is not a lower threshold in existence for each and every country.)

Taking all this into account, the DFI may further define different thresholds for internal and external nominee directors. Internal staff members may not be allowed to hold more than one or two board seats, while external ones may hold up to three or even more nominee positions. While staff members may not have board seats outside of the DFI, external nominees may have; so here also a total ceiling of approximately five or fewer board seats needs to be considered.

A nominee can take one committee position but not necessarily more than two. Some DFIs avoid board chair positions because of the additional liability, reputational exposure and time commitment, but normally do allow for chair positions within committees.

For internal staff, there may be further restrictions, for example, with regards to seniority. Some DFIs do not allow either management board members or junior staff to sit on boards. It is also recommended to have rules to which extent directors or vice presidents should sit on the board of companies for which they have a portfolio responsibility at the same time. Also, some departments such as credit or special operations may not nominate their members to boards of investee companies because of their dedicated focus on the interests of the DFI only. Finally, for retirees or ex-staff, it may be advisable to have a cooling-off period to introduce them gradually as external nominee directors and to avoid that in their final months the future retirees build a new 'portfolio' of board positions with the investee companies they have been actively involved with.

For internal staff members, but to a lesser extent also for external ones, tenure can play a role in providing for some rotation and avoiding that some nominees have too many board seats. A tenure of approximately two years for staff, once renewable; and two to three years for external nominees, up to three times renewable, is recommended. As a general rule, an external board member should not be involved for more than 8 to 10 years (in total) with the same investee company. The renewal clause offers the possibility to check to which extent the nominee has achieved objectives and is still the best possible candidate for the board. One thing board members, in general, find hard to understand is that, given the maturity stage of the company or its strategic needs, they may not be the best candidates anymore (while they have been three to five years ago, for example) and should make place for others.

What potential conflicts need to be kept in mind?

To properly assess the potential of conflicts of interest it is helpful to differentiate between different types of conflicts.

1. Personal conflicts: Such conflict may affect an internal or external nominee and is embedded in his or her personal background with the investee.
2. Structural conflicts: These are employment-related conflicts and only relate to internal nominees. More specifically, these can be:
 - **Oversight or supervision conflicts:** an individual is representing the investee company's interests (board mandate) versus the shareholder interests (investment mandate)
 - **Competition conflicts:** the board member is also responsible for assessing competing businesses
 - **Debt & equity conflicts:** the employer of the board member provides debt and equity to the business which could create conflicts, especially in case of distress of the investee company
 - **Seniority conflicts:** conflicts that arise out of the fact that internal staff as nominees may have reporting lines that create conflict with the portfolio function of the DFI, for the investee company
 - **Time conflicts (work load/availability):** conflicts may arise over time with changing roles and responsibilities

In general, there are two ways of addressing conflicts of interest, either to avoid conflicts completely or manage conflicts by providing guidance how to mitigate risks. Communication and transparency, also vis-à-vis the investee company, are key when going for the latter option.

With regards to internal staff as nominee directors and conflicts arising thereof, the following measures can be taken into account:

- Avoid internal staff as nominees when providing different investment products or avoid providing different investment products to the same client in the first place.
- Also avoid internal staff becoming board members in listed investee companies to avoid any perception of insider trading.
- Resort to internal staff as nominee candidates that are not involved in the portfolio management and likewise do not report to a more senior staff member involved in the portfolio management with the same investee company. At times, it may be useful to shift reporting lines or portfolio responsibility to allow a specific and ideally qualified internal staff member to sit on a certain board.
- Sensitize internal staff about their duty of loyalty from the perspective that they cannot use board seats to gather information about competing companies in which they then invest and need to be transparent about similar types of conflicts.
- Spend time in training internal staff about their different duties on boards (representing the interests of the investee) vis-a-vis the role as a shareholder or limited partner in a fund. It occurred to us frequently that staff members think they represent the interests of the DFI when they sit on the board of the investee company in the same way they do when being part of an advisory committee of a fund, where it is actually their duty to represent the interests of the limited partner (see further below, pages 35). Training is also needed if the DFI engages in corporate or institutional board seats. Under such arrangement,¹³ a staff member will at least

“Process steps help to keep board members engaged and able to fulfill their responsibilities.”

William George
McKinsey Quarterly, February 2013

practically act in the best interest of the DFI that s/he is representing on the board. Potential conflicts between the investee company and the DFI as an institutional board member are difficult if not impossible to solve.

- Spend time educating the investee company. They may often ask for a DFI staff member on the board but it is important for the investee company to understand that the board is, in general, not the place where shareholders should be represented and express their views. We have also observed that often nominee directors are 'misused' as shareholder representatives in shareholder meetings of the investee company. Such practice conveys a very wrong message and should be refrained from. It is better to give proxy to the chair of the board rather than the nominee in cases where the DFI as shareholder agrees with all agenda items. In cases where there is a need for discussion or disapproval, the nominating shareholder should send a staff member as proxy and shareholder representative.
- Keep the tenure of internal staff as nominees short, so that the potential for conflicts can be revisited at least every two years and new candidates can be identified once the responsibility or local availability of the current staff member sitting on the board has changed.
- Analyse potential conflicts of interest at the time of the nomination and monitor them continuously. The legal department or a specialized conflict of interest department/unit/working group may play a role in this.

How shall the nominee director report or share information?

Connected with the problem of potential conflicts of interest is to which extent a nominee director should report back to the DFI as nominating shareholder. In general, board material, conversations, etc. need to be treated confidentially because of a board member's fiduciary duty towards the investee company. Here again, we mainly recommend to be transparent vis-à-vis the nominee and the investee company and define the rules of communication early on in the nomination letter to the nominee as well as in the notification letter to the investee company. Of note, however, is that the nominee director should not be the primary source of information from the investee company. S/he can support this process but should not be a substitute for normal portfolio supervision by a portfolio officer.

Especially for listed companies an exchange between board members and shareholders may be forbidden because of the risk of insider trading and should be prevented accordingly. In some countries, even for non-listed companies, it may be forbidden or there may be specific regulation applicable. The starting point here again is to check the legal environment of the country the investee company is registered in.

In cases where that ongoing information exchange between nominee and nominating shareholder is legally allowed -as it is often the case for corporate board seats- the DFI and its nominee director still have to consider that certain discussion items on the board are confidential. It is thus recommended from the outset to clarify to which extent the nominee needs to keep matters discussed at board level confidential. The intuitive solution here is to treat everything confidential and have the nominee ask for approval at board level if s/he wants to share certain information with the

shareholder. Often, the DFI as nominating shareholder will have agreed to regularly receive the board agenda and meeting minutes as well as other pertinent information; in such a case a conversation about those items does not need to be kept confidential anymore. In case of doubt, it is recommended, however, that the nominee clarifies with the chair or all board members which items s/he can share with the nominating shareholder. It can be useful for the chair of a board, in particular if several DFIs are involved, to provide equal reporting about board meetings to all shareholders or allow for general reporting back unless an item is specifically highlighted as confidential. It is important for transparency purposes to make sure that all shareholders are equally informed. In turn, the investment staff should be prepped to ask for certain information from the company directly rather than their nominee director. All shareholders should be uniformly informed that too close a communication between a nominating shareholder and its nominee director may be disadvantageous and even disruptive for the board.

The issue becomes more complex when the nominee director reports on the ambiance in a board meeting or the behaviour of fellow board members. We would consider those things confidential and not to be made part of the reporting. Practically that may be difficult to achieve, which is another reason why nominee directors cannot be considered fully independent, even in the case of external ones. Their loyalty may always lie with the DFI, who may potentially consider the nominee for another board seat, leading them to convey information about the board and the investee company only to further foster their relationship with the nominating shareholder rather than the investee company. Here, we would recommend limiting the information request from the DFI to processes, such as the length of board meetings,

the attendance record of board members, whether a board evaluation takes place, etc. while refraining from asking for comments on the general ambiance at the board or the behaviour of other board members.

Given all these challenges, one DFI has taken an innovative approach whereby, as long as the legal environment allows, they allow for an open communication between nominee and nominating shareholder and obtain a sign-off by the investee company at the time of nomination. This DFI would not nominate an internal candidate if legally the nominee cannot share information with the DFI. In such a case there is clarity in the fact that everything that happens at board level can be shared with the nominating shareholder. It also reduces the potential conflict for internal staff members as nominees. The down-side of this solution, however, is that the onus remains entirely with the investee company to be very careful in explicitly spelling out confidential board items over time that should not be shared back with the nominating shareholder. The sophistication level of some investee companies may not be advanced enough to fully understand the implications of their original sign-off about this communication rule at the time of nomination. Another down-side is that it creates a special right of one board member towards others.

Another DFI always strives to nominate two board members, one internal and one external. Under such an approach it is also clear that the internal staff member will share all information back with the nominating shareholder, effectively representing the nominating shareholder at board meetings. There is unfortunately no silver bullet to define limits of communication in detail here and luckily, interests are not aligned only in limited situations, such as a crisis of the investee

company or a potential exit or increase in shares of one nominating shareholder or a delay in certain obligations vis-à-vis one nominating shareholder (compliance or ESG-wise). Yet, it is important to lay down the principles of communication early on and decide whether the investee company should be aware that everything, nothing or certain clearly defined items are shared between nominee and DFI as nominating shareholder.

How the nominee director should be monitored?

Who is responsible for monitoring the board performance?

In general, the board itself is responsible for its performance. Most corporate governance codes recommend an annual evaluation that is either undertaken by the chair of the board or by a third party. Some codes foresee such a third party facilitation at least every three years. It is important to understand that the board normally only informs shareholders and other stakeholders about the fact that the evaluation took place and about some details of the process, but not about its results. The evaluation can only be meaningful if board members can rely on its confidential contents. In some African countries (Uganda for example) the contents and results of a board evaluation in a bank need to be shared with the central bank. One can imagine that such an evaluation does not necessarily reflect the full truth and is almost always (too) positive. As a matter of fact, some of these boards are actually now undertaking two evaluations—an 'official' one central bank and an 'unofficial' one for their own use that better reflects reality.

We mention this in such detail because there is a legitimate interest of the nominating shareholder to judge the performance of the board in general and its nominee director in particular. We feel that this is a very troublesome undertaking, though. We have seen situations in which investment teams join board meetings as invitees (or observers, see more above on page 20) to judge the performance of the nominee. They may or may not be transparent about their reason for joining the board meeting. In any case the information obtained may remain very limited and the overall undertaking may cause harm in the relationship between the nominating shareholder and the nominee director.

We suggest that as a nominating shareholder the DFI should focus more on the process, i.e. the frequency of board and board committee meetings, the presence record of the nominee and other board members and the existence and annual undertaking of a board evaluation. Vis-à-vis the nominee director, we suggest focusing on the objectives as laid out in the nomination letter. At least once a year, the investment/portfolio team should check with the nominee director to what extent the progress on the objectives has been achieved. This is by nature high level but any further and deeper involvement may compromise the individual decision-making capacity of the nominee director.

Does the nominating shareholder have a responsibility for the nominee director?

The quick answer here is that legally the nominating shareholder does not have any responsibility in case that the nominee director fills an individual board seat and has a personal mandate rather than an institutional mandate¹⁴. Still, reputation-wise, there is a risk. Not only the investee company, but also the outside world, may perceive the nominee director as the representative of a particular DFI. It is, thus, paramount to clarify in the communication that board decisions do not bind the nominating shareholder and that the nominee acts in his or her personal capacity.

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“This is a thoughtful guide that addresses all the important factors that DFIs, and for that matter, other institutional investors, need to consider to make smart decisions nominating directors to the Boards of investee companies.”

Mike Lubrano,
Managing Director,
Corporate Governance, Cartica Capital

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The exit of a nominee director

When should the nominee director resign?

There may be several causes or reasons for a nominee director to resign. One is related to time availability. If the nominee director feels that s/he cannot commit sufficient time, then s/he should also bear the consequence and resign from the board. Another reason is any wrongdoing or perception thereof of the investee company (and to a lesser extent the nominee him- or herself). Because of potentially reputational issues, it is paramount that the nominee director is very alert to any wrongdoing, corruption or bribery within the investee company. Finally, not only illegal activity but also a general discontent with the board processes and decision-making or the overall quality of the controls of the company (internal audit, risk management and internal controls) can at one point be reason enough to resign, particularly, if the nominee was not able to make any progress towards his or her original objectives.

A crisis situation of an investee company deserves special mention. Many DFIs have special operation teams that deal with companies in crisis. At the time of transfer of the investee to the special ops team or even in a prior consultation phase, it is recommended to critically review whether the nominee should continue on the board of directors. The potential for conflicts of interest may be very high since special operation teams, by default, prioritize the DFIs interests while the nominee director needs to act in the best interest of the investee. In a crisis situation interests may more likely be misaligned. Yet, likewise in a crisis situation, it may be legally undue to revoke the board member. If the special operations team

together with the legal/corporate governance department comes to the conclusion that the nomination should be withdrawn, it is paramount to check whether that revocation would come at an undue time and create any legal risks. The situation is similarly delicate if the nominee director him- or herself considers a resignation in a crisis situation.

Who is responsible for revoking the directorship?

It is again important to carefully distinguish between nomination and appointment. While the nominating shareholder can revoke the nomination, the appointment's revocation needs to be validated by shareholder approval. It has to happen if the director resigns, but not necessarily only because the nominating shareholder revokes the nomination. So there is a potential risk that the DFI as nominating shareholder is revoking the nomination but the nominee him- or herself does not resign and the remaining shareholders do not revoke the appointment. To address this risk, and given that the revocation of the nomination may be a quite contentious step anyhow, we suggest to 'manage' the nomination by limiting the tenure. If the nominating shareholder is not fully convinced how the nominee would blend in a particular board it is better to limit the original tenure to one to two years, and not to renew it in case of an issue, rather than revoking the nomination at a certain point of time.

Corporate/institutional board seats

The contents of this guidebook focus mainly on board positions that are an individual obligation. Most jurisdictions would allow only for those. Some, however, also allow for the DFI to take a corporate or an institutional board seat (such as Italy, France, Luxembourg and 17 West and Central African countries that are part of the OHADA treaty on the harmonization of business law). In such a case the actual board member, who needs to be a staff member, will be appointed as a 'permanent representative' of the DFI for the duration of the DFI's board mandate. Such a set-up may be of advantage for boards that act like shareholder assemblies but it in turn potentially hampers potentially the distinction between board and shareholder level at the time it is appropriate in the development of a company.

While corporate seats often offer more flexibility to share information between the nominating DFI and its nominee director, when such is enabled by law, the DFI should be clear about which staff member can attend and avoid rotation among different staff members. As mentioned above, there should be one 'permanent representative' for the DFI. The DFI should also voluntarily apply with certain requirements the DFI puts out regarding the necessary skills and expertise of the individual being chosen for a corporate board seat.

With regards to potential liability, an institutional position offers arguably a better protection for the individual but it could also make the individual feel less responsible for what s/he is doing as a director and board member. There is also an institutional risk in a sense that potential plaintiffs may welcome the 'deeper pockets' of the institution sitting on the board rather than the individual as the defendant.

Executive positions of a nominee director

In some cases, the DFI may even be offered an executive position in a one tier board or the management board of a two tier board. Most DFIs would shy away from those because of reasons of liability. It is important to highlight that all decisions by the nominee are made in his or her own capacity. To avoid conflicts of interest the DFI should consider waiving an additional role on the (supervisory) board or

with additional non-executive directors because practically it would lead to the result that the DFI is reviewing its own work on an executive level. While we do not necessarily recommend avoiding an executive position, the DFI should choose only one of the two possibilities with any particular investee or company, either executive or non-executive, but not both at the same time.

Nomination to bodies of a private equity fund

In principle, a fund needs to be treated differently to a corporation, at least if the fund uses the form of a partnership rather than a corporate form. Originally the fund is based on a partnership model in which the DFI as a limited partner (LP) engages the general partner (GP) or fund manager to achieve a specific investment purpose over a defined period of time. The relationship between the LP and the GP mainly relies on explicit contractual measures, which are entered into at the outset of the partnership.

Conceptually, the LP is a passive partner in the management of a fund. Investment and risk management considerations, for example, are entirely delegated to the GP. In most jurisdictions—and this is a major obstacle in enhancing the governance role of the LP—the LP will lose the limitation of liability if it interferes in management. As a consequence, LPs have limited rights to participate in day-to-day operations, challenge decisions of fund managers, or approve major transactions as board members in a publicly listed company would do.

Normally, at least if the fund is based on a partnership, there are two bodies to which the DFI as limited partner can send nominees, one is the advisory board or committee and the other one is the investment board or committee, the latter being very close to an operational/executive function.

The role of the nominee in the advisory board/committee

An advisory committee (AC) or board¹⁵ must not be confused with a board of directors in a corporation. The former is established

as a sounding board for the GP and is often comprised of the largest LPs but not necessarily all LPs. Because of the threat to lose the limitation of its liability, ACs comprised of LPs have only a very limited authority. As the name indicates their main mandate is to advise and not to decide although over time their scope has been broadened. Most of the time they will only review the valuations of investments undertaken by the GP/fund manager and decide in case of conflicts of interest of the GP and/or the fund manager. They may also have decision-making power with regards to the extension of the investment period, key man risk or other issues explicitly mentioned and referred to the advisory committee in the investment agreement. The authority of ACs may vary from one jurisdiction to another. Some DFIs may thus ask for safe harbour clauses that would ensure that the LP does not lose the limitation of its liability because of being involved in certain 'decisions' at the level of the AC.

It is important to highlight that in most jurisdictions the representation of the LP in an AC does not create a fiduciary duty.¹⁶ So unlike in a corporate board of directors the member of the AC can represent the interests of the LP when involved in the AC. There is only a bona fide obligation—but this is not entirely clear—to raise potential conflicts of interest so that decisions are not made to the detriment of the fund if the interests with one LP and the fund are for whatever reason are not (fully) aligned. The lack of a fiduciary duty towards the interests of the fund naturally opens the door for internal staff to be nominated on ACs. Normally, it would be the investment officer who has also undertaken the investment in the fund and sits on the AC as part of his or her portfolio management. Since the AC

15

Unfortunately, both names exist and the advisory board of a fund must also not be confused with an advisory board in a corporation that again is a different organizational body often used in family business to make them familiar with the idea of non-executives getting involved. Such advisory boards do not have any decision-making authority whatsoever.

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There are some jurisdictions, however, where AC members do have fiduciary duties towards other LPs.

meetings are also less frequent and less formal than board meetings a staff member may indeed have more than five of such AC seats in different funds. Too many AC seats, however, may also create a time commitment issue. The DFI should, therefore, limit the total number of AC seats a staff member can have.

The below table summarizes the differences between the AC in a fund and a board of directors in a corporation:

The role of the nominee in the investment board/committee

The investment committee (IC) or investment board is normally the body which takes the investment decisions of the fund. Apart from the GP and fund manager, LPs are at times also offered the right to nominate a member.¹⁷ From a liability point of view this is again troublesome since, as LP, the DFI should not be involved in the decision-making of the fund. Yet, for first time funds it is often paramount to tap the existing investment practices and expertise of its LPs.

We would suggest limiting such involvement to first time funds and again deciding on which side the LP wants to be involved. An involvement of a staff member in the IC may again create a conflict of interest with another staff member being involved in the AC. Such conflict can again be solved if external candidates are selected for the IC, but then, again they may not offer precisely the investment decision expertise the fund is looking for. Even if this conflict is avoided the DFI would still remain involved in parallel in the AC and IC thereby practically reviewing its own decisions.

Task	Board of Directors	Advisory Committee
Power/ Authority	Represents the company. It may delegate powers to management and subcommittees.	A committee nominated by investors that typically represent investor interests and do not represent the fund or its manager.
Purpose/ Scope	Provides oversight and strategic guidance to the company. Some jurisdictions require this by law.	Provides advice to fund manager. Duties are not deemed managerial / mainly focused on well-defined issues.
Duties/ Power	Oversees company strategy and supervises the activities of the management and the investment committee.	Depending on the jurisdiction, activities that are not deemed management , e.g., conflict resolution, review of evaluation, etc.
Profile of Members	Individuals with financial and business expertise that are required for decision-making by a board of directors (in principle, the same people as under the advisory	Savvy and knowledgeable investors, professional, regional knowledge is key. Also strong business judgment as well as knowledge of various sectors that are most relevant for growth.
Relationships	Directors should have excellent business contacts globally.	Local market knowledge & global perspective of PE industry and multi-sectors.
Fiduciary Duties	Board members have fiduciary duties , i.e. they have to act in the best interest of the company.	Members of an advisory committee do not have fiduciary duties to the fund or investors but must act honestly and in good faith.
Expenses/ Costs	Annual lump sum, at least sitting fees and expenses are commonly paid.	Out-of-pocket expenses borne by the fund or LP.

This is a declining practice, since overall LPs become more sensitive about conflicts of interest.

Corporate fund structures

Another layer of complication is created in the case where the fund is not formed as a partnership but as a corporation. While in such case there will be a board of directors, practically it may often more closely follow the agenda of an AC rather than a full-fledged board. Liability-wise, however, the directors in such a board have a fiduciary duty and

cannot be regarded as AC members representing their respective LPs only. We suggest treating such assignments as proper board positions. Unlike for boards in corporations, however, and because of the focus on investment decisions of a fund in general, internal staff may much more frequently be considered for boards of corporate funds.

A word to the wise

The above offered a lot of food for thought and recommendations on how best to nominate directors to the boards of investee companies. In the end, however, if you honour the principle that the nominee needs to act in the best interest of the investee, try to analyse up-front the potential for conflicts of interest, and overall regard the selection of the nominee as a recruitment process where you want to get the best possible match for the investee company—there is not much more one can do to avoid things going wrong. This is of course a simplified reduction but hopefully a good ending note to highlight the main drivers and principles in

your decision-making process. In the process of drafting this Guidebook the represented institutions in the Committee on directorships of the DFI Working Group, namely DEG, EIB, FMO, IIC, IFC and PROPARCO exchanged a lot of practices and ideas and are in general happy to get in touch with you in case that your DFI needs support.

An initiative of the DFI Corporate Governance Working Group

